FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D.C.

In the Matter of **The Greene County Bank** **Strafford, Missouri** (Insured State Nonmember Bank)	**FDIC-93-160b**

Appearances:

Lynn R. Dadisman, Esq. and *John J. Oldenburg*, Esq. for Federal Deposit Insurance Corporation.

Charles W. German, Esq. and *Brant M. Laue*, Esq. for Respondent.

RECOMMENDED DECISION

ARTHUR L. SHIPE, Administrative Law Judge:

This proceeding was instituted on July 26, 1993, by the issuance of a Notice of Charges and of Hearing (Notice). The proceeding was instituted for the purpose of determining whether an appropriate order should be entered against Respondent under the provisions of section 8(b) of the Federal Deposit Insurance Act (12 U.S.C. § 1818(b).

Oral hearings were held in the matter of January 24, 25, 26, and 27, 1994, in Springfield, Missouri. Post-hearing initial and reply briefs have been filed, and on September 28, 1994, Respondent submitted a supplemental brief, which is hereby received.

Based upon the entire record, including exhibits, witness testimony, and my observation of the demeanor of the witnesses, the following Discussion of Facts and Law, Findings of Fact, Conclusion of Law, and Order, are entered.

DISCUSSION OF FACTS AND LAW

Respondent

The Respondent is a small Bank of about 15 employees with one central office and two branches, all located in suburban Springfield, Missouri. In February 1993, it had assets of $18,798,000, and Tier 1 capital of $1,481,000, with an adjusted equity capital to adjusted assets ratio of 7.9 percent. At the time of the hearing its assets were stated to be $16.5 million. Tr. 619.

The Respondent is largely controlled by Bernard H. Rullman, Jr. It is owned by a holding company of which Mr. Rullman and his wife, Joann are the principal shareholders. Its directors are Mr. Rullman, Mrs. Rullman, their 26 year old son, Tyler Rullman, and two bank employees.

The holding company has accumulated assets besides the bank stock, and is viewed as a possible source of financial strength to the Bank by the Federal Reserve Board. It has no significant debt and owns a securities

portfolio of common stock in unaffiliated organizations with a market value of $313,000, that were acquired at a cost of $185,000. The Federal Reserve Board has recently given the company a composite rating of 2. Resp. Ex. 259.

Bernard H. Rullman, Jr.

Mr. Rullman holds a degree in mathematics, and an MBA in finance, from Indiana University. He was employed by Commerce Bancshares, Inc., a large regional bank, for about seven years, and served as president of two local branches of that firm. He was later employed by Merrill Lynch where he was trained as a stockbroker. In 1979, he purchased the Respondent with borrowed funds which he has managed to repay from its earnings.

The Respondent is well capitalized, and has with the exception of 1991, when its earnings were $24,000, enjoyed adequate earnings every year it has been under Mr. Rullman's management.

However, the Bank has been the subject of various criticisms by examiners in a number of areas, including funds management, interest rate risk and liquidity.

Mr. Rullman was the Respondent's principal witness at the hearing. He is obviously an individual of strong intellectual abilities, and is an astute banker in many respects, who has had extensive and successful experience in the business. However, he seems to listen to his own drummer in banking matters, which has brought him into conflict with the officials having supervisory responsibility for the Bank. A memorandum prepared in connection with the February 1991 examination refers to

Mr. Rullman's continued arrogant and abrasive attitude toward the FDIC examiners during the examination. Resp. Ex. 227.

Respondent's Financial Structure

Beginning in the early 1980s, during a period of high interest rates, Respondent began acquiring securities in the expectation of lower rates. The first purchases were non-callable municipal bonds. With the decline of interest rates, these bonds appreciated in value. Thereafter Ginnie Mae and Fannie Mae mortgage backed securities were bought. As interest rates further declined, and those securities correspondingly increased in value, more purchases were made. None was purchased with a coupon yield of less than 10 percent.

At the time of a 1991 examination by the FDIC, the Bank held over $8.3 million in such securities out of total assets of $19.8 million; appreciation on the securities, not reflected in the Bank's balance sheet was $373,000. In February 1993, this figure was $511,000.

Mr. Rullman viewed the high earnings of the long-term securities and their appreciation as a cushion against possible loan losses and erosion of loan collateral, as well as protection against the risk of higher interest rates, which would increase the short-term interest paid on deposits funding the securities.

Mr. Rullman's views have been consistently rejected by the examiners and other involved FDIC officials. They

have continually insisted that the Bank approach a balanced position of short-term assets and short-term liabilities. Mr. Rullman does not consider this to be a sound investment policy, and claims that his view is validated by the positions of large New York banks, which are said to have substantially increased their long-term assets in recent years to meet risk-based capital requirements.

The 1991 FDIC examination report stated that the Respondent was so liability sensitive that a small increase in the level of interest rates would have a severely adverse effect on its earnings level, leading to possible insolvency if higher interest rates would continue over a prolonged time span.

Prior Proceeding

A Notice of Charges based on the 1991 examination, was issued against the Respondent on August 9, 1991, alleging, *inter alia*, that it was engaged in unsafe and unsound banking practices by failing to maintain an adequate percentage of rate sensitive assets to rate sensitive liabilities, and that this imbalance unduly positioned the Bank in a speculative posture for profit or loss based on interest rate fluctuations.

In its Answer, the Respondent denied the allegations of unsafe and unsound banking practices, and stated that the appreciation of its securities portfolio had a fair market value of over $600,000, and that this protected it from any reasonably foreseeable change in interest rates. Respondent further stated that it had never had a loss year, that it had achieved high earnings in varied interest

rate environments, and had always earned over one percent of assets per year under present management.

In an apparent reference to its then contemplated trading of financial futures, Respondent indicated that it was "taking action to address perceived risks associated with interest volatility and has made this action known to the FDIC." Answer, p. 2.

Future Transactions

The Answer in the prior proceeding was filed on September 6, 1991. On September 9, 1991, Respondent opened a position in financial futures. By September 30, 1991, it had a futures position of 60 short futures contracts on 90-day U.S. Treasury Bills, and 20 short futures contracts on Eurodollars. It had also sold 10 call options on U.S. Treasury Bonds.

Respondent has incurred losses on its futures position of over $500,000 in an 18-month period, more than $300,000 of which was lost between September and December 1991. Respondent continues to maintain a similar short position in financial futures, as well as a smaller long position.

Memorandum of Understanding

On February 14, 1992, the Respondent executed a Memorandum of Understanding (MOU) with the FDIC, and the Missouri Commissioner of Finance, resulting in a discontinuance of the proceeding that had been instituted on August 9, 1991, seeking a cease and desist order. The MOU covered, among other subjects, interest rate risk,

and futures contracts, and included the following provisions:

1. (a) Within 30 days from the date of this Understanding, the Board shall develop a written plan of action to reduce the bank's interest rate risk exposure.

   (b) Within 30 days from the date of this Understanding, the Board shall develop and adopt a written policy governing the use of futures contracts as a method for reducing the bank's interest rate risk. The policy shall incorporate the guidelines set forth in the FDIC Policy Statement entitled, "Statement of Policy Concerning Interest Rate Futures Contracts, Forward Contracts and Standby Contracts," a copy of which is attached to this Understanding. In addition, for each instance in which the Bank engages in the use of futures instruments to reduce interest rate risk, the policy shall require the following:

      (i) Identification of the specific cash market assets or liabilities to be hedged with futures contracts, the amount of cash market assets or liabilities to be hedged and the desired maturity of the hedge;

      (ii) Selection of the appropriate futures contract (Treasury Bills, Eurodollars, etc.) and the establishment and verification, on a monthly basis, of a correlation between (a) the dollar amount

of changes in the aggregate market value of futures contracts and, (b) the change in the fair value of, or the interest income or expense associated with, the item or group of items to be hedged. For purposes of this paragraph, correlation shall be determined in accordance with Generally Accepted Accounting Principles;

(iii) Identification of the exposure of [sic] be hedged, e.g., the potential earnings effect that results from the bank's ratio of rate sensitive assets minus rate sensitive liabilities to total assets ("gap");

(iv) If applicable, determination of the effective cost of the hedge, i.e., the average cost of funds that has been "locked in";

(v) Determination that the futures hedge is a cost-effective alternative compared to other potential strategies to reduce interest rate risk;

(vi) Determination of the proper hedge ratio, i.e., the number of futures contracts needed to cover the identified exposure in the cash market without unduly jeopardizing the bank's capital account;

(vii) Determination, for the number of futures contracts purchased, of the aggregate change in market value of those futures contracts that results from a 300 basis point change in the underlying interest rate of the futures contracts purchased;

(c) Within 30 days from the date of this Understanding, the Board shall devise and implement an interest rate risk exposure/rate sensitivity policy that establishes reasonable parameters, at all time horizons, for both the ratio of rate sensitive assets to rate sensitive liabilities, and the ratio of rate sensitive assets minus rate sensitive liabilities to total assets. This policy could be incorporated into the funds management policy addressed in paragraph 9 of this Understanding.

Allegations and Response in the Instant Proceeding

The instant proceeding was instituted on July 26, 1993, and is based on the 1991 FDIC examinations, as well as subsequent FDIC examinations conducted as of April 3, 1992 and November 1993, and a State of Missouri examination conducted as of March 10, 1993.

This Notice again alleges that Respondent has been operating with improper funds management by failing to maintain adequate percentages of rate-sensitive assets to rate-sensitive liabilities, and by placing excessive reliance on short-term volatile liabilities to fund long-term assets, that Respondent's futures position was taken without

documentary analysis of the effect it would have on Respondent's financial condition, and without compliance with the FDIC Policy Statement on futures transactions. (Statement of Policy Concerning Interest Rate Futures Contracts, Forward Contracts and Standby Contracts," 44 Fed. Reg. 66,673 (1979); amended by 45 Fed. Reg. 18,116 (1980) and 46 Fed. Reg. 51,302 (1981).

The Notice further alleges that Respondent has failed to comply with the MOU, that it has engaged in hazardous investment and trading practices, and that it has operated with management whose policies are detrimental to the Bank, and which jeopardize its deposits.

In its Answer to that Notice the Respondent again denied that it had engaged in unsafe and unsound banking practices, and asserted that its practices and overall condition meet any reasonable definition of safety and soundness. It stated that its securities portfolio had an appreciation of over $500,000, representing a gain of 5.22 percent, which placed it in the top one percent in the country, that it has continued to achieve high earnings in varied interest rate environments, that its current earnings place it in the top one percent of U.S. banks, that it does not speculate on interest rate fluctuations, that its primary equity capital exceeded 9.84 percent. Respondent denied that it has placed excessive reliance on volatile or short-term liabilities to fund long-term assets, and stated that the allegations concerning an alleged imbalance between rate sensitive assets and liabilities on invalid assumptions and insufficient analysis of its financial structure.

With respect to its futures position, Respondent claimed that it was established as a proper hedge of its liabilities, that it had clearly identified the elements of its hedging program in connection with those transactions, that there was a high correlation between its liabilities and its futures contracts, that it had made an analysis of the overall effect of the futures on the Bank, and had complied with the FDIC Statement of Policy on futures. It denied that there was any material potential for significant loss from its futures position, and asserted that losses on its futures contracts were incurred as a hedge of its liabilities.

Respondent denied that it had failed to comply in any material respect with the MOU.

Primary Issues

As the foregoing discussion shows, this proceeding revolves primarily around Respondent's funds management, more specifically its "liability sensitive" position resulting from the use of short-term liabilities to fund long-term assets. It is claimed by the FDIC that although the liabilities would reprice within a short time if interest rates rise, thereby increasing interest expense, there would be no comparable increase in interest income to Respondent to cover the increased expense.

To meet this criticism, Respondent has engaged in futures transactions to hedge its interest rate risk.

It should be noted that the FDIC's main allegation is that the Respondent is operating with an excessive interest rate risk *on a balance sheet* basis. It has not sought to

show that Respondent is in fact now operating with an excessive interest rate risk. In order for that to be shown, the overall interest rate posture of Respondent, including its futures position, would have to be taken into account.

FDIC contends that to include the effect of the futures position would distort the interest rate analysis. It is also alleged that the futures contracts have not been acquired in accordance with applicable standards, or with adequate documentary analysis.

GAP Analysis

Although there are various methods used to determine an institution's interest rate risk, the FDIC examiners primarily use what is known as a GAP analysis.

That analysis entails the categorization of a bank's assets and liabilities by time periods within which they would be expected to reprice in the event of interest rate changes. The time periods are, typically, zero to three months, three months to six months, and six months to one year. The amounts are cumulated for the successive periods. At least 75 percent of an institution total assets and liabilities are expected to be included in this analysis.

Various calculations are then made of the cumulated assets and liabilities for each time period: Liabilities are subtracted from assets to obtain a net position of assets (positive or negative); total assets are divided into the net position figures to derive the net position as a percent of total assets; and assets are divided by liabilities to arrive at a percentage of the former to the latter.

In the absence of explained and special circumstances the examiners expect the percentage of assets to liabilities to be in the 80 to 120 range, though this is not a prescribed standard, and the FDIC has no policy establishing that as a norm.

In order to estimate the effect of an interest rate change on earnings, the combined net position and net position as a percent of total asset figures are multiplied by the interest rate change being measured. This computation is based on the assumption that the assets and liabilities instantaneously reprice and the change is sustained for at least a year.

According to the described analyses in the February 1991 examination, Respondent's assets likely to be repriced within one year were 16.37 percent of liabilities, and the estimated effect on income of a one percent increase in interest rates would have reduced 1990 earnings of $212,000 to approximately $73,000. Corresponding percentages of liabilities to assets for the 1992 and 1993 examinations were 37.4 and 27.

The FDIC recognizes that this test is "simplistic" and has shortcomings in that it does not take into consideration the fact that assets and liabilities may not reprice instantaneously at the same levels and does not consider interest income payment.

Mr. Rullman claims here that the assumption of maturity dates of assets is unrealistic for Respondent because of early repayments, that its Ginnie Mae mortgage backed securities were purchased with coupon yields higher than current interest rates with early payments in mind. The coupon yield reflects the interest rate

paid by the mortgagors who will repay principal faster when their interest rates are higher than current rates.

He also stresses that Respondent's current high earnings, its strong capitalization, and off-book securities appreciation is not reflected in the GAP analysis.

In June 1992, a CPA for IBAA Securities Corporation (IBAA) conducted a study of Respondent that included a GAP analysis showing the effect of its off-balance sheet hedges on its interest rate risk. According to that analysis, Respondent's total position is somewhat asset sensitive rather than extremely liability sensitive, as claimed by the FDIC. FDIC Ex. 30, p. 11.

The FDIC rejects this analysis because it is claimed that the amount used to reflect the impact of the hedge is not explained. This argument is considered below and is found not to be persuasive.

Risk-based Capital and Interest Rate Risk

Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Public Law 100-242, required the Banking Agencies to revise their risk-based capital guidelines to take adequate account of interest rate risk. FDICIA also required the agencies to prescribe final regulations implementing section 305 and to establish transition rules to facilitate compliance with those regulations.

In August 1992, the agencies issued a notice of proposed rulemaking soliciting comments on a possible framework for revising risk-based capital standards to

take adequate account of interest rate risk and other matters.

Based on the comments received from that notice, the agencies issued for public comment a proposed supervisory model that would measure interest rate risk exposure from the effect that a specified change in market interest rates would have on the net economic value of a bank's assets, liabilities and off-balance-sheet positions.

The proposed supervisory model would entail the division of a Bank's assets and liabilities into time bands based upon their remaining maturities or nearest repricing dates. Each time band position would then be multiplied by a "risk weight" developed by the agencies to represent the estimated sensitivity of the economic value of that position to a specified change in market interest rates. The risk-weighted positions of all balances would be summed to produced a net risk-weighted position. That net position would represent the estimated change in the bank's net economic value and would be the primary quantitative measure used to assess a bank's level of interest rate risk.

Under this approach, banks would be required to hold capital for interest rate risk sufficient to cover the "excess exposure," which is defined as an aggregate dollar decline in the net economic value of the institution exceeding a threshold of 1 percent of assets.

Different assets would be accorded varying risk bases. For example, Fannie Mae securities, along with cash and Federal Reserve deposits, would be assigned a zero risk basis. Mortgages on one to four family homes would assigned a 50 percent risk basis.

The dollar amount of capital required would be incorporated into the risk-based capital requirements by increasing the bank's risk-weighted assets. Because the amount of risk-weighted assets forms the denominator of the risk-based capital ratios, any increase to that denominator will lower a bank's measured ratio. Specifically, the dollar amount of the capital requirement for interest rate risk would be multiplied by 12.5, which is the reciprocal of the 8 percent minimum risk-based capital ratio. This amount would be added to the total of the bank's risk-weighted assets for purposes of calculating the risk-based capital ratios.

Mr. Rullman sought to apply the proposed model to Respondent's assets, liabilities and off-balance-sheet positions using the interest rate risk worksheets accompanying the proposal. Resp. Exs. 305 and 306.

According to his computations, Respondent's risk-based capital ratios in the event of an upward move in interest rates of 200 basis points would be 22.53 percent, and 38.98 percent in the event of a comparable downward movement, if the off-balance sheet position is included.

Without that position, the corresponding percentages would be 16.94 and 90.93. As noted, the minimum risk-based capital ratio is 8 percent. It is contended that these computations demonstrate that Respondent does not have an excessive interest rate risk.

The FDIC does not criticize the substance of the methodology used, or the accuracy of the computations, but it points out that the model employed is only a proposal for comment and has not been adopted, and may never be implemented in its present form. The FDIC

also notes that the computations were not made until shortly before the hearing, and thus contends that Respondent could not have previously relied upon this method of determining interest rate risk. Mr. Rullman stated that although the computations were only recently made, he was previously aware of what the results would be. In view of Respondent's high proportion of zero and 50 percent risk based assets and the wide margin by which Respondent's ratios would exceed the required 8 percent, the claim has some credibility.

Respondent argues that it is unfair to proceed against it without regard to the described proposals, and that it is not fair "to evaluate the Bank by admittedly outmoded standards," (the GAP analysis), which place it in the untenable position of contesting this action based on the outmoded standards, while going forward in a regulatory environment governed by up-to-date standards. It cites *Citizens State Bank v. FDIC*, 751 F. 2d 209, 214-16 (8th Cir. 1984) and *In re Pettinari*, FDIC No. 91-248b (Nov. 17, 1992) in support of this argument.

Futures as a Hedge of Interest Rate Risk

Although Mr. Rullman was of the opinion in 1991 that the Bank did not have excessive interest rate risk, after failing to dissuade FDIC officials from instituting a cease and desist proceeding on the issue, he decided to enter the futures market in an effort to hedge the risk perceived by the FDIC. As stated, the FDIC does not consider those contracts to be a hedge against the claimed

interest rate risk, since it argues that they were not properly and prudently acquired in compliance with the FDIC Policy Statement on futures.

Thus, the FDIC continues to maintain that Respondent has a grave interest rate risk, which has not been removed by the futures contracts, while Respondent contends that it does not have an excessive interest rate risk, and that if it did, the futures contracts have removed it.

The FDIC futures Policy Statement contains various general requirements and seven specific requirements pertaining to the use of futures by Banks. It is claimed that Respondent continuously failed to comply with two of the general requirements and three of the specify [sic] requirements.

Among the provisions of the FDIC Policy Statement allegedly not adhered to by Respondent are the following:

> Banks that engage in futures, forward and standby contracts should only do so in accordance with safe and sound banking practices. Levels of activity should be reasonably related to the bank's business needs and capacity to fulfill its obligations under these contracts. In managing their investment portfolios, banks should evaluate the interest rate risk exposure resulting from their overall activities to ensure that the positions they take in futures, forward and standby contract markets will reduce their risk exposure and policy objectives should be formulated in light of the bank's entire asset and liability mix. The following are minimal guidelines to be followed by banks eligible under State law to participate in these markets.

* * *

The board of directors should consider any plan to engage in these activities and should endorse specific written policies in authorizing these activities. Policy objectives must be specific enough to outline permissible contract strategies and their relationship to other banking activities. Record keeping systems must be sufficiently detailed to permit internal auditors and examiners to determine whether operating personnel have acted in accordance with authorized objectives. Bank personnel are expected to be able to describe and document in detail how the positions they have taken in futures, forward and standby contracts contribute to the attainment of the bank's stated objectives.

The board of directors should establish limitations applicable to futures, forward and standby contract positions; and the board of directors, a duly authorized committee thereof, or the bank's internal auditors should review periodically (at least monthly) contract positions to ascertain conformance with such limits.

The bank should maintain general ledger memorandum accounts or commitment registers to adequately identify and control all commitments to make or take delivery of securities. Such registers and supporting journals should at a minimum include:

(a) The type, nature of position (long or short) and amount of each contract,

(b) The maturity date of each contract,

(c) The current market price and cost of each contract, and

> (d) The amount of money held in margin accounts.
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> To assure adherence to bank policy and prevent unauthorized trading and other abuses, banks should establish other internal controls including periodic reports to management, segregation of duties, and internal audit programs.

Respondent argues that a policy statement does not have the force of law. However, it should be noted that the MOU requires Respondent's futures policy to incorporate the guidelines contained in this Statement of Policy.

Board Approval of Policies

FDIC contends that the futures contracts were acquired without board approval, and that adequate policies and limitations on the trading of futures have not been established by Respondent's board. The record contains a number of documents, which Respondent claims, refute these allegations, but the FDIC argues that these documents are seriously flawed.

On April 23, 1991, Mr. Rullman presented to the Board of Directors proposed revisions to the Bank's Funds Management and Investment Policy to include as authorized investments for the Bank, among other financial instruments, interest rate futures. Secretary of the Board Owen moved for the adoption of the revised policy, and upon the second of Joann Rullman, the motion carried. FDIC Ex. 31, p. 30.

As pertinent here, the revised policy reads as follows:

> Earnings are a vital and necessary component of the investment portfolio. A high yielding portfolio will provide greater growth in capital and the income will itself provide liquidity. To increase earnings, the Bank selectively mismatches asset and liability repricing. The size of the asset/liability mismatch depends on a careful assessment of the inherent risk that interest rates may not move as anticipated. The Bank shall maintain the flexibility to change any mismatch quickly by capital markets instruments mechanisms such as interest-rate futures, swaps and future rate and purchase agreements up to an amount equal to the total of investments and loans. The responsibility for developing strategies and tactics for achieving the Bank's Asset/Liability Management rests with the Asset/Liability Committee (ALCO).

FDIC Ex. 16-b-2.

This statement of policy seems to set forth a rationale for Respondent's mismatch of short-term liabilities and long-term assets, and the use of futures in connection with this mismatch, and limits the latter "to an amount equal to the total of investments and loans." This would comprise the majority of the Bank's total assets, which were $19,867,000, as of February 26, 1991.

The FDIC Examination Manual suggests that interest rate futures may be used "to hedge against unprofitable fluctuations in interest rates when imbalance exists in a bank's rate sensitivity position." FDIC Ex. 1-a, p. 5.2-1.

On June 27, 1991, the board passed a resolution, on motion of Mr. Owen, and seconded by Mrs. Rullman,

approving the execution of customer agreements by the Bank with several brokerage firms for the purpose of trading various financial instruments, including futures. FDIC Ex. 31, p. 34.

As stated, the first purchase of futures contracts by Respondent occurred on September 9, 1991. On the following day, the subject was discussed at the board meeting. The minutes of the meeting state, "Chairman Rullman presented the bank's hedging position. (See supporting documents in file.)" According to Mr. Rullman he explained to the board the basics of how the futures hedge would work. The supporting documents consist of a section from the Wall Street Journal containing the price listing of the involved futures and a sheet setting forth futures acquired, the number acquired, the price, value "per tic" ($25.00) per contract and for the position. FDIC Ex. 31-b.

The FDIC argues that the minutes do not support Mr. Rullman's description of the discussion that took place at the meeting, that his account is uncorroborated, and that there is nothing in the minutes evincing approval of the contracts entered on the previous day, or of those entered on subsequent days.

There is no basis for disbelieving Mr. Rullman's version of the meeting, which is somewhat corroborated by the documents referenced in the minutes. There is no explicit approval of futures activity recorded in the minutes. In view of the prior adoption of a policy embracing the possible use of futures, the authorization to open a futures trading account, and the later board action, it can scarcely be contended that this activity was not

approved, though the minutes should have explicitly so indicated.

The October 1991 board minutes state that "Chairman Rullman reviewed the current status of the bank's hedging program." At that time there were 80 futures contracts open.

Following criticisms of its hedging program by FDIC Examiner Julia Poitevin during a visitation in October 1991, Respondent engaged Peat Marwick to assist it in developing policies to govern its hedging program. Pursuant to that engagement a proposed policy statement was furnished.

At the December 30, 1991 meeting, the Board of Directors adopted a revised policy on Asset Liability Management, and established the membership of a Asset/Liability Management Committee (ALCO). The adopted policy delegated "responsibility to ALCO for the formulation, revision and administration of appropriate policies. FDIC Ex. 31, p. 43. The membership of the ALCO was the same as that of the Board, except for Tyler Rullman, who was not included on the ALCO. A portion of the policy statement authorized ALCO to use financial futures, and included much of the language contained in the Peat Marwick document. This language was subsequently included in the MOU and is quoted above. FDIC Ex. 16-b-5.

FDIC claims that the requirement of the MOU that the futures policy incorporate the guidelines of the FDIC Policy Statement on this subject was not complied with. However, the substance of those guidelines was adopted in detail.

Beginning in January 1992, the ALCO became the official body responsible for policies and oversight of the futures program. Although its membership was virtually identical to that of the Board of Directors, since April 1993, the board approves *qua* board the minutes and actions of the ALCO. The Bank's futures position has been consistently reviewed by ALCO and the board.

Limitations

Respondent relies on computations contained in the February 23, 1992 ALCO minutes as establishing the limits, and the basis therefor, of its futures trading.

The record includes an unsigned copy of those minutes, as well as a corrected copy of the signed minutes. FDIC claims the minutes were "altered." The changes consist of corrections of arithmetic, and the substitution of one sentence for another. Although it would seem that the changes should have been officially approved by a subsequent ALCO meeting, in view of the nature of the alterations they are not relevant to the substantive matters in dispute here.

The corrected minutes contain the following table.

Liability	Amount	Time in Quarters			Contracts
N.O.W.	$2,180	X	4	=	8.92
1 Year C.D.	3,604	X	8	=	28.83
6 Month C.D.	6,710	X	8	=	53.68
Savings	1,320	X	4	=	5.28
M.M.I.	3,170	X	8	=	25.36
TOTAL					122.07

FDIC Ex. 32, p.2.

The dollar amounts state Respondent's liabilities in thousands, and the numbers 4 and 8 under Time in Quarters refer to futures contracts on Treasury Bills or Eurodollars.

Immediately below this table the minutes state:

> The above calculation was determined to effect 100 percent hedge position. The committee discussed the desirability of a total 122 contract hedge and decided that the partial hedge of 80 contracts would, if not totally, reduce the effects on the Bank liabilities sufficiently to protect from loss the repricing of the liabilities.[1] Currently the strong earnings of the bank were in line with the attached report of The Effects of Repricing and Changes in Interest Rates and the Futures Hedge for The Greene County Bank in 1992.

The referenced contracts are 90-day U.S. Treasury bill and Eurodollar futures. The 90-day Treasury bill has a face value of $1 million. It does not have a coupon rate. The interest rate is determined by the amount of discount from the face value at which the bill is traded. Thus, a bill sold at issuance for $985,000 (or 98.5 percent of 100 par) will earn 6 percent on an annualized basis, or $15,000 (one fourth of $60,000, the annualized return at 6 percent) Resp. Ex. 241, p. 7; FDIC Ex. 16-b-1, p.2.

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[1] A prior version of the minutes reads: "At this time it was determined that eighty (80) contracts were sufficient to protect against interest rate risk." The number required for a total hedge is incorrectly computed as 100 contracts.

The futures contract is an obligation to make or take delivery of the Treasury bill by a maturity date. (In practice, delivery does not ordinarily occur – the contract is closed by the purchase or sale of an opposite position.) The arithmetic applicable to the principal and interest of the bill applies to the future contract from which it is derived. A movement of one percent in the interest rate of the bill will affect the value of the contract by $2,500 ($1,000,000 x .01 ÷ 4). Therefore, to hedge an amount of deposit liabilities for one year will require four times that amount in future contracts on 90-day T-bills. This is known as the stack method of hedging. Tr. 497, 665, 779; FDIC Exs. 16a, p. 26 and 16-b-1, p. 2; Resp. Ex. 241, p. 7. The same principles apply to the Eurodollar futures, which are based on dollars deposited abroad.

The foregoing computations are also worked out in a document entitled "Greene County Bank Interest Rate Strategy." That document states that to fully hedge the Bank's liabilities for one year would require 70 contracts.

The FDIC contends that there is a conflict between the two computations, and that it is impossible to ascertain whether the limitation is 70 contracts to effect a full hedge for one year, or 80 to effect a partial hedge for longer periods. The FDIC also points out that the earlier April 1991 authorization was based on investments and loans.

Mr. Rullman stated that the Interest Rate Strategy calculations are illustrative of the manner by which the number of hedged contracts are determined, and that the ALCO minutes contain the Bank's limitation on the

number of contracts to be used. His statement is supported by the language of the Strategy document, which states for instance, that 70 futures "*would* result in the number of futures necessary to hedge the bank's liability position for a period of one year . . . and that a "higher ratio *would* be necessary to adjust for a security which does not correlate exactly 100%." (Emphasis added) The April 1991 bank policy specifying limits in terms of assets was superseded by the subsequent decision to hedge liabilities.

Mr. Rullman gave this explanation of the reasoning underlying the computations by which it was determined that some of the liabilities should be hedged for a period longer than one year:

> We took each liability that was to be hedged and determined a time based upon its sensitivity to interest rates for which we wanted to hedge it. We determined that NOWs and Savings were less subject to interest rate changes than the one-year CD, the six-month CD, and the money market investment accounts. So we applied a higher time period, a two-year time frame for the one-year CD, the six-month CD, and the money market account, and left the NOW and Savings at one year. We performed the calculation that came out that if we had a total hedge based upon the liability, total liabilities at that time, that the total would be 122.07 contracts. Since we were limited by the Memorandum of Understanding, we left the contracts at 80, which left our agreed-upon calculation of capital, plus the 70 percent security appreciation, minus a 300 basis point shift in interest rates

reduction from the futures contracts at a comfortable level above 6 percent.

Tr. 734.

The referenced provision of the MOU required the Bank to maintain Tier 1 capital of 6 percent plus an amount equal to a possible 300 basis point loss on its futures position, less 70 percent of the net unrealized gains on its securities. Paragraphs 1(b)(viii) and 11(a)(2).

It is concluded that the discussed ALCO minutes do establish limitations on the amount of short futures contracts that may be employed by the Respondent to hedge its liabilities.

Identification of Risk

In April 1991, when Respondent first adopted a policy on the use of futures, which was about five months before the first contracts were sold, it appeared to contemplate using futures as a hedge for assets. FDIC Ex. 16-b-2.

When Examiner Poitevin conducted a visitation examination in October 1991, after the first 80 contracts were sold, Mr. Rullman was still uncertain whether the futures were considered to be a hedge for assets or liabilities. FDIC Ex. 8-b. The effect of the hedge on the securities portfolio was being considered. FDIC Ex. 8, p. 11 and 10-a.

It seems undisputed that given Respondent's position, heavily structured toward long-term assets and short-term liabilities, the effects of a general increase in interest rates would be to reduce the value of the long-

term assets, since their value is related inversely to interest rates, as well as to increase the cost of funds used to finance those assets.

To hedge either the value of the assets or the cost of liabilities against the risk of increased interest rates would entail the acquisition of financial instruments that increase in value with an increase in interest rates, and thus offset the higher interest paid on deposits, and the depreciation of assets. Thus, the same futures instrument could be used to hedge asset value or liability costs.

In October 1991, Respondent made a commitment to the FDIC to engage Peat Marwick, who was its outside accountant, to provide assistance in developing a hedging program. That assistance included a determination of whether the Bank should be an asset or liability hedger. This decision rested to some extent on tax considerations; the tax exempt status of municipal bonds might be lost if they were hedged. Tr. 682.

Before the end of 1991, Respondent determined, in consultation with Peat Marwick, that it would be a liability hedger. Peat Marwick made an interest rate futures correlation analysis comparing changes in Respondent's liability expenses in the form of interest paid on deposits with changes in the interest rates earned on 3-month treasury bills and Eurodollars, and found that a significant correlation exists between the changes in rates paid for deposits and rates reflected in futures on the treasury bills and Eurodollars. This correlation is confirmed by regression analyses that have been regularly computed by Mr. Rullman, and does not seem to be disputed here by the FDIC.

However, the FDIC points out that this correlation, though necessary for a proper hedge, does not establish the amount of risk to be hedged. As shown above, Respondent claims to have hedged its deposits in the approximate amount of $17 million for either one or two years.

In order for a hedge to work properly, losses on the hedge instrument should be offset by gains on the items being hedged. Respondent has sought to show that it has in fact recouped savings on interest expense to offset losses on its futures transactions. In an attempt to comply with Paragraph (b)(ii) of the MOU, Mr. Rullman prepares a report monthly for the ALCO setting forth cumulative changes in interest expense and the Bank's futures position. Resp. Ex. 272. The results are presented in graph form here for 1992, and for January through June of 1993. Resp. Ex. 273.

For those periods losses on the futures were under $200,000, while cumulative savings on interest costs were nearly $500,000.

The FDIC contends that this comparison is misleading because the amount of deposits declined 19 percent during 1992, and interest payments accruing from a shrinkage of deposits should not be offset against losses on the futures position. FDIC further argues that since Respondent purported to only effect an approximate 65 percent hedge (80 contracts out of 122 for a full hedge), it is not appropriate to compare future losses with all savings on interest costs. These criticisms would suggest that the cumulative interest savings are over-stated. However, if that is the case, and they were lower, the correlation

between such savings and future losses would be closer than that depicted.

The FDIC has presented graphs on interest savings on deposit and losses on futures separating the results for 1992 from those of 1993, January through October. FDIC Ex. 28, pp. 4 and 5. The 1992 graph is similar to that introduced by Respondent. The 1993 graph shows that savings on interest expense continued, amounting to about $40,000, that losses on Respondent's futures position amounted to less than $10,000, and widely fluctuated during the year. These results were largely caused by the purchase in 1993 of long contracts on treasury bills, an activity that is also criticized by the FDIC, and discussed below.

Respondent's futures trading was based upon the total amount of its short-term liabilities. Although a tight correlation between interest rates on those liabilities and the 3-month treasury bills and Eurodollars, which is reflected in the utilized futures, was demonstrated, the FDIC continues to insist that Respondent has failed to undertake any analysis to determine whether the losses experienced on its futures contracts would be offset or recovered from some other source of income.

It is concluded that this allegation has not been sustained, and that the level of futures trading has been shown to be *reasonably* related to the Respondent's business needs and capacity to fulfill its obligations under those contracts. Despite losses on the futures, Respondent has, with the exception of 1991, when losses on the futures were taken before the effect of repriced deposits

occurred, continued to maintain sufficient earnings. Without the savings on deposit interest this would not have been possible. To maintain that no relationship has been shown to exist between interest expense saved and losses on future is to ignore substantial data.

Respondent is criticized for its assumption, for purposes of futures calculations, that a one percent increase in interest rates will affect all of its deposit liabilities by one percent. While it is an assumption, it would seem to be a necessary one since it cannot be determined in advance what specific interest rates may be required to attract deposits if those rates change.

Similar assumptions are included in the GAP analyses presented by the FDIC. There the assumption is that an institution's assets and liabilities subject to possible repricing within one year will reprice concurrently at the same levels. To show the income effect for a given change in interest rates assumes that all assets and liabilities in the zero to 12 months bracket reprice instantaneously, and that the rate is sustained for a year. Tr. 105, 108, 165, 168; FDIC Exs. 2-d and 3-e.

In positioning a hedging model depicting the relationship between changes in interest expense and interest rates it is assumed that repricing occurs at 3, 6, and 12 month intervals with the various deposit instruments. Tr. 211-222; FDIC Exs. 2-f, 2-g and 6-d.

All of the foregoing assumptions, as well as the hypothesized one percent interest rate movement that is sustained for one year, may be useful, but they do not necessarily reflect events that occur in practice. Given the demonstrated use and necessity of assumptions as to the

effects of possible interest rate changes, it has not been shown that the assumptions as to the effects of possible interest rate changes on Respondent's liabilities is unreasonable.

Implicit in the FDIC's criticisms of Respondent's claimed liability hedge is the apparent premise that any hedge of interest rate risk should be confined to the gap between short-term assets and short-term liabilities, and that to the extent that increased interest expense can be expected to be offset by an increase in earnings from loans, the increase in expense cannot legitimately be hedged. There is no authoritative statement cited for this assumed restriction.

The Policy Statement requires that levels of future activity be *reasonably* related "to the bank's business needs," that futures activity reduce "interest rate risk exposure" and that "policy objectives should be formulated in light of the bank's entire asset and liability mix." The Examination Manual contains similar language. The stated premise does not follow from these policies.

The futures trading program of Respondent has clearly been formulated in connection with its business needs and in light of its entire asset and liability mix. Respondent's asset and liability mix includes relatively large amounts of securities, having an appreciated value far higher than their book value. The assets are financed by short-term deposits. As previously stated, an increase in interest rates would tend to reduce the appreciation in the securities and increase the cost of the liabilities. An increase in interest rates would generate offsetting income from the financial futures.

The FDIC insists that Respondent has not evaluated the full implication of its futures transactions. However, it construes any reference to their offsetting effect on the value of assets as indicative that the futures are not really hedges at all. Similarly, it deems any reference to the tax consequences of the futures position as negating the claim that the futures are a hedge.

Respondent's adequate earnings, despite significant losses on its futures contracts, would indicate that it has the capacity to fulfill its obligations under those contracts.

Despite the foregoing, the FDIC, citing Examiner Poitevin's testimony, argues that from September 1991 through October 1993, this $20,000,000 Bank acquired futures contracts aggregating approximately $500,000,000 for the ostensible purpose of reducing a risk it had never identified. Brief at 45.

The FDIC seems to insist that unless interest rate risk is derived through some form of a GAP analysis it has not been identified. As stated, it also rejects a GAP analysis prepared for Respondent by a CPA because that analysis allegedly included an insufficiently explained effect of the futures position. FDIC Ex. 30.

An amount of $20,000,000 was included in that analysis to show the impact of hedging. This was manifestly an allowance for the "stack" effect of 90-day instruments, previously explained. Eighty contracts on 3-month futures contracts would equal $20,000,000 for one year.

As the FDIC points out, this firm recommended that consideration be given to reducing the number of T-Bill

contracts used by Respondent to hedge its liabilities. It suggested that 40 contracts were needed to hedge a gap of approximately $10 million or four contracts for each $1 million, which is consistent with the formula used in its GAP analysis. The questioned use of the $20,000,000 figure in that analysis is not justified.

Even if interest rate risk can only be determined through an accepted GAP model, Respondent had available to it the analyses performed by the FDIC and State examiners, as well as IBAA. FDIC argues here that since Respondent disagrees with these analyses they do not satisfy the requirement that risk be identified.

The arithmetic in these studies is not questioned by Respondent. Its claim is that the results do not demonstrate that the Bank's financial viability would be jeopardized by an increase in interest rates. The futures contracts were sold in an effort to oblige the contrary views of the FDIC. It seems incongruous for the FDIC to now insist that acquisition of the futures position was improper because Respondent has not performed the tests repeatedly conducted by its examiners.

Long Contracts

As previously noted, the price of treasury bills and futures thereon varies inversely with interest rates. A rise in interest rates will lower the price of the bills and futures. Therefore, to hedge against a possible rise in interest rates the hedger goes short in the futures market. He will obtain a profit if interest rates rise because the price of his futures declines.

Also, as noted, treasury bills are traded at a discount to their face value, the amount of the discount being determined by the applicable interest rate. At maturity the bill is worth its face amount, $1,000,000. Its value increases as the time to maturity shrinks. The price of the futures reflects the value of the bill. If interest rates remain steady the price of the futures increases as it moves toward expiration because of the shortening of time before the underlying bill reaches maturity and becomes worth its face value. The result of the foregoing is that a short position on a treasury bill will lose money as the future contract moves toward expiration with no change in interest rates. Conversely, a long position will gain money.

Respondent's futures contracts were short, and thus subject to losses when held over time as they moved toward expiration. Considering interest rates to be low and stable, Mr. Rullman developed a plan by which the Bank would establish a long position in futures that would partially offset expected losses in its short position. FDIC Ex. 21-b-5. It was found that more distant future contracts trade at a higher percentage discount to par, and that the gain on 40 long contracts, expiring later than the short contracts would largely offset losses on 40 short contracts against which the longs were spread, as well as recoup the costs incurred on an additional 80 short contracts. At the time of the State examination in March 1993, Respondent had acquired 40 long contracts, and 120 short contracts, for a net position of 80.

By thus trading longs and shorts Respondent made about $100,000 on long contracts in 1993, and virtually eliminated the cost of the hedging program.

The long contracts were bought to generate income to offset losses being incurred on the short contracts. Though related to the hedge, the long contracts did not hedge a balance sheet item. They were hedges of the short futures hedge.

The strategy for trading longs was formally approved by the ALCO on March 29, 1993.

It is unclear whether the FDIC Policy Statement covers this type of activity, or if it is deemed "speculative" and if so, whether it is permissible for banks. The FDIC Manual of Examination Policies states: "Speculation in futures contracts is generally not an appropriate bank activity. However, this type of activity may be acceptable as part of a trading function by a sophisticated institution which has adequate capital, sufficient internal controls and management expertise." p. 5.2-10. Presumably, Respondent is not described there, though the strategy used evinces some sophistication in the use of futures to generate income.

In reference to the required board policies on futures trading, the Examination Manual states, "The policy should include gross and net limits pertaining to each permissible contract." p. 5.2-10. This seems to refer to the type of trading in issue here.

As indicated, the strategy is stated to be confined to an environment of steady and low interest rates. The risk of loss on the longs is that interest rates will rise. Since they are spread against the short position on similar instruments, with a moderate difference in time, losses on the longs would be expected to be offset by gains on the shorts. The actual risk is that this will not occur. That risk

would seem to be less than the risk inherent in the matching of interest rates and maturities of assets and liabilities in conventional banking practices.

Internal Records and Control

FDIC claims that there were no internal audit procedures for the Bank's use of futures. Using a spread sheet, Mr. Rullman developed on his personal computer a monthly report for the ALCO. That report contains a list and description of open futures contracts, the price at which they were acquired, the current settlement price, the value of the position, the value of a minimum movement in price per contract and per position, the trading results for the year, and current month, and the change in value of the position resulting from a 300 basis point change in interest rates.

The current reports also include a running comparison of changes in interest rate expenses on deposits and losses or gains on the futures positions, as well as a regression analysis of the relationship of those changes. Resp. Ex. 279.

The futures broker furnishes comprehensive monthly reports on the Bank's futures position. These are reviewed by ALCO and the Bank's board. Tr. 803-806.

Upon request for direction by Respondent, Peat Marwick suggested that two general ledger accounts with subledger accounts, and two accounts for the income statement be established for the futures program, and these were established as recommended. Tr. 718-719; Resp. Ex. 247.

The dominant role of Mr. Rullman in the trading of futures contracts is a matter of legitimate concern to the examiners.

Paragraph 10 of the FDIC Policy Statement on futures states:

> To assure adherence to bank policy and prevent unauthorized trading and other abuses, banks should establish other internal controls including periodic reports to management, segregation of duties, and internal audit programs.

It is obvious that this policy statement is directed at larger institutions where any futures trading is conducted by lower echelon personnel.

The Examination Manual states that a Bank's policy on futures should delineate trading authority, and that this authority "should be delegated only to individuals which demonstrate the specific knowledge and expertise necessary to properly transact those permissible activities and strategies in a safe and sound manner." p. 5.2-10.

The literal applications of the Policy Statement requirement to Respondent is impossible since its trading is done by top management. As noted, consistent reports are made to the board on all the trades and their status. Though it might be advisable for there to be a sharing of duties among management with respect to this futures activity, the feasibility of a bank of 15 employees having different persons adept in trading futures is not established.

Futures trading confined to top management, subject to constant oversight by the board, accomplishes for a bank as small as Respondent the objectives of paragraph

10 of the Policy Statement in assuring adherence to bank policy, the avoidance of unauthorized activity, and the restriction of trading to the most competent persons available.

Naked Options

On September 13, 1991, Respondent sold 10 call options on U.S. Treasury bond futures. It received a premium of $8,065.95 for the sale. The transaction obligated Respondent to deliver bond futures to the holder of the options upon exercise of the options. The options would be exercised only if the involved futures price increased to an amount over the strike price specified in the option. (I am unable to ascertain the strike price from the account statements. Resp. Ex. 281). A rise in the futures price would occur if interest rates were to decline. The option buyer is willing to pay a premium for the possibility that this will occur. The seller by receipt of the premium is exposed to the risk of lowering interest rates. There is no specified limit to the amount of loss that may be incurred. It may exceed the amount of the premium.

Since it did not own the bonds, or futures thereon, these options are termed "naked." The Examination Manual states, "Selling uncovered or naked options is highly speculative and has no place in a bank's investment program." p. 3.2-9.

Respondent contends that these options were covered by its securities investments since any loss on the options would result from a decline in interest rates which would simultaneously increase the value of its

securities. This does not meet the requirements of a covered option. Early in his discussions with regulators Mr. Rullman pledged not to engage in any additional transactions of this nature, and none has occurred since the one sale of the 10 options in September 1991.

REMIC

The Notice alleges that on February 11, 1992, the Respondent Bank purchased a Federal National Mortgage Corporation Real Estate Mortgage ("REMIC") in the amount of $150,000, that this was an unsafe and unsound banking practice in that it was acquired without documentary evidence in the Banks' records of any analysis and its financial effect on the Bank, or of compliance with an FDIC policy statement entitled, "Supervisory Policy Statement on Securities Activities," 57 Fed. Reg. 4029 (1932). This Statement became effective on February 10, 1992, the day before the purchase in issue.

The Notice alleges specifically that the REMIC was acquired without documentation criteria established by the board on the use of REMICs, and without documentation of whether the instrument was a "high-risk mortgage" security. It is further alleged that as of April 3, 1992, the Bank had suffered a loss of $2,000 on the purchase.

In its Answer, Respondent denied that the purchase was unsafe and unsound, and asserted that a proper analysis had been made, and that the Policy Statement had been complied with in all material respects. It denied that it had suffered any loss on the transaction and stated that it had already been paid off in accordance with the

projections in the prospectus which were available to the FDIC examiners.

It will be noted that it is not alleged that the purchased instrument was a high risk investment, or that no analysis thereof was made. The allegations are that documents pertaining to these matters were not created.

There is conflicting testimony pertaining to whether a relevant prospectus was obtained by the Bank prior to its purchase of the REMIC. As indicated, Respondent claims that it was, and that it was furnished to the examiners during the April 1992, examination. Tr. 722. Examiner Poitevin testified that Mr. Rullman stated at that time that he did not have the prospectus prior to the purchase. Tr. 299-303. There are notes by another examiner confirming her testimony. FDIC Ex. 16b-12.

Mr. Rullman, on the other hand, produced the prospectus with some notes that were stated to have been made prior to the purchase referring to alternative pay out times. Resp. Ex. 239, p. 5-38.[2] It is not possible to

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[2] The examiner's note states, in part:

> When questioned about compliance with the Statement of Policy, he said, "Well, let's just go through it item by item." I told him it was quite comprehensive and he then said that his analysis was limited to the fact that
>
> 1) Securities have paid off in 2 years and
> 2) Solomon Bros. estimated it to be 145-170 range.
>
> Mr. Rullman's note on the prospectus reads: 150 2.08 135 3.5.

reconcile the conflicting testimony on the matter. However, I am unable to ascribe fabrication to either side, but conclude that it was an unfriendly exchange and that the conflict reflects a miscommunication or a misunderstanding.

Both the examiner notes and those in the prospectus refer to an expected pay-off of the bond within two or three years. The applicable test which, it is claimed, was not shown to have been performed, is a price sensitivity test to determine if the value of the bond would change more than 17 percent with a shift in interest rates of 300 basis points. Mr. Rullman contends it is readily obvious that the value of an instrument paying off within two of three years could not change by 17 percent with a three percent change in interest rates. He gave his reasoning on this at the hearing. It was credible and has not been refuted. Tr. 946-947. The results were confirmed by an analysis by IBAA in June 1992. FDIC Ex. 30, p. 65.

The following conclusions can fairly be drawn with respect to this transaction. It was not a high risk instrument. Mr. Rullman determined this to his satisfaction prior to the purchase. The notes evidencing his analysis are cryptic, but reflect an acquaintance with the essentials and nature of the specific investment as well as related concepts. It is doubtful that all of this could have been conveyed solely by oral communications with the broker.

The numbers 145-170, 150 and 135 refer to the Public Securities Association's standard prepayment model (PSA) and represents an assumed monthly rate of prepayment. Resp. Ex. 239, p. S-6. The numbers 2.08 and 3.5 state in years the expected life of the security.

There was no investment policy specifically authorizing this purchase, but it was within the guidelines that were in effect. It was paid off within a year, without any loss to the Bank.

Liquidity

It is contended by the FDIC that Respondent's method of funding possible liquidity needs is unsafe and unsound. It is not claimed that the Bank is illiquid in the sense that it could not readily convert its assets into cash. Its large holdings of marketable securities could either be sold, or used as collateral for borrowings.

At the time of the hearing Respondent had unsecured lines of credit at two banks for $600,000 each, credit at the Federal Reserve Bank for $300,000, and securities pledged at another bank for potential drawing of credit of over $3.5 million. It had securities of about $8 million.

FDIC argues that the risk posed to Respondent stems from a potential increase in interest rates, resulting in more costly deposits, or borrowing to fund assets. If longer-term higher yielding assets were sold under those conditions it would be at declining values. The FDIC contends that in a well-run bank short-term maturing assets are assumed to be available to fund short-term volatile liabilities if the liabilities leave the bank. It is again stressed that most of Respondent's assets are funded by short-term liabilities.

Mr. Rullman disagrees with these contentions, and maintains that the same effect as having short-term assets

can be had by holding higher-yielding pledged securities which can be readily drawn upon. Tr. 648.

The FDIC's arguments on liquidity are a variation on its interest rate risk position. The effect that the futures position would have on the bank if interest rates increased is completely ignored, as previously stated.

Deference to the Opinions of Examiners

The FDIC asserts its position largely through the opinions of Examiner Poitevin. She is obviously a capable examiner with a good grasp of financial futures as they relate to banking, but she takes an extremely rigid and critical approach to the subject. If her views are adopted as general policy in this area, it would be very difficult for banking institutions to utilize futures in their operation, particularly one as small as Respondent. It is not believed that this approach reflects current policy.

Examiner Poitevin expressed a large number of criticisms of the practices of Respondent, concluding in each instance that the subject practice is unsafe and unsound, and could potentially have an abnormal risk or loss to the bank, to its shareholders, and to the Deposit Insurance Fund.

It is recognized that the logical possibility exists that these criticisms are valid, and the bank could nevertheless be in good shape, but the question does persist of how a bank so riddled with unsafe and unsound practices could achieve good earnings, and increase its capital, during an economic recession.

Respondent has filed a supplemental brief referencing the holding in the recently decided case, *Seidman v. Office of Thrift Supervision*, Nos. 92-3722/3729/5392, slip op. (3rd Cir. September 14, 1994) (1994 WL 498653).

The court there held that an unsafe and unsound practice is an imprudent act posing "an abnormal risk to the financial stability of the banking institution, and that, "a cease and desist order is designed to prevent actions that if repeated would carry a potential for serious loss."

Although it is evident that many of the acts and alleged acts that have been deemed unsafe and unsound by the FDIC examiners in this proceeding would not meet the tests laid down in the *Seidman* opinion, there are other grounds for declining to issue the cease and desist order being sought here.

Respondent's June 30, 1993 call report, made available shortly before the instant Notice was served on July 26, 1993, reports earnings on assets of 2.74 percent, earnings on equity of 35.1, and a Tier 1 capital ratio of 9.2 percent. Resp. Ex. 258.

The FDIC, *Citing Sunshine State Bank v. Federal Deposit Insurance Corporation.*, 783 F. 2d 1580 (11th Cir. 1986), contends that since in the opinions of its examiners, Respondent's activities in dispute here constituted unsafe and unsound banking practices, and that in their opinion the proposed cease and desist order is the appropriate remedy, it must be adopted unless their opinions are demonstrated to be unreasonable.

Although the *Sunshine* opinion establishes the deference that must be accorded to the opinions of examiners

in areas of their competence, it also recognizes that those opinions are not unreviewable, especially on factual matters which require no particular training or expertise.

The examiner opinions offered here are heavily mixed with factual claims, and as to those claims the opinions are quite contentious and selective.

It is proposed, generally, that a massive and onerous cease and desist order be imposed on Respondent because of the interest rate risk claimed to be reflected in its balance sheet. The justification offered to support the proposed order consists of GAP analyses of its assets and liabilities. Resolutely ignored is the risk-based capital position of Respondent.

Also determinedly ignored is the effect of the off-balance sheet futures position on Respondent's interest rate risk. The justification offered for this is that the position was not acquired in compliance with appropriately written policies and procedures. Even if this contention were true it would not nullify the financial effect of the futures.

It is claimed, as discussed, that Respondent has never identified the risk being hedged. However, the close correlation between treasury bill and Eurodollar interest rates and rates on bank deposits is conclusively shown, and not disputed. The converse movement of savings on Respondent's interest expense and costs of the futures is computed monthly, and is clearly demonstrated.

It is contended that there is no policy limitation on the amount of hedging contracts that may be used by Respondent. This claim is based on an asserted conflict

among different documents on the subject. Upon any reasonable interpretation of the documents there is no such conflict.

A GAP analysis prepared by a CPA reflecting the effect of the futures position on Respondent's interest rate risk is discounted on the grounds that the basis for the amount of futures included is not known, although that basis can readily be determined. Tr. 496-497, 666, 779-780.

Respondent is criticized for failing to determine the effects of the futures contracts on its general condition, but any consideration of the relation of the claimed hedge to its assets, capital, or taxes, is construed as proof that the risk being hedged has not been identified.

It is not believed that the holding of *Sunshine* can be applied as fully to the relatively undeveloped and uncharted policies in issue here as to those areas within the recognized expertise of examiners.

Proposed Order to Cease and Desist

The first paragraph of the proposed order would require Respondent to cease and desist from,

> engaging in hazardous securities investment and/or trading practices, including operating with excessive risk of loss due to interest rate fluctuations, resulting from, without limitation, the sale and/or acquisition of government securities, futures contracts, and mortgage derivative securities without adequate analysis and assessment of the interest rate risk involved and the effect of such activity on the Bank's earnings and capital;

This paragraph seems to rest on a number of assumptions that, as shown above, the weight of the evidence does not support. It apparently assumes, for instance, that Respondent is operating "with excessive risk of loss due to interest rate fluctuations." To reach this conclusion the effect of the claimed financial futures hedge and Respondent's risk based capital must be completed [sic] ignored.

It should be pointed out that the FDIC Examination Manual contains these directions for examiners:

> When futures are utilized for hedging purposes the effect of this activity should be reflected in the interest rate sensitivity analysis. For example, if the effect of a futures hedge is to lengthen liabilities, then the par value of the futures contracts should be subtracted from rate sensitive liabilities. Any adverse affect (sic) futures and forward contracts have on the interest rate risk of the institution should be noted in the comment sections of the interest rate sensitivity analysis. Any inappropriate speculative positions or positions which do not adhere to the institution's policy should be mentioned on the examiner comment and conclusion page.

FDIC Ex. 1-C, p. 5.2-10.

The futures position of Respondent was severely criticized following examinations, but the requirement stated in the first quoted sentence has not been complied with. The criticisms do not vitiate the economic effect of the futures. The only study in the record reflecting the impact of the futures position upon Respondent's interest rate risk shows the Bank's position to be moderately asset

sensitive, not excessively liability sensitive, as claimed by the FDIC. FDIC Ex. 30, p. 11.

Moreover, using the pending risk based capital standards, Respondent has been shown to be positioned to withstand its exposure to interest rate risk, with or without financial futures. Resp. Exs. 305 and 306.

This paragraph of the proposed order also assumes that the described securities investments were made "without adequate analysis and assessment of the risks involved." Tr. 582. Again, the evidence does not support this assumption. Long-term securities were purchased over a period of time pursuant to a deliberate strategy that included the expectation of an economic recession, possible loss on loans, erosion of collateral, high earnings on the securities, and the appreciation of value on previously purchased securities. Whatever flaws that were inherent in this strategy it has not been shown to have been through lack of analysis.

The same assumption is made about the futures transactions. It is not disputed that the initial contracts were sold before adequate board policies were in place. But to rely on that after extensive policies have been adopted as a result of examiner criticism and the execution of an MOU seems rather capricious, and it is not clear that this is being done. The critical argument is that no such policies were ever established.

The justification offered at the hearing for applying this paragraph to futures was that they were acquired "without adequate documentation to support that [they] are in compliance with the FDIC's policy statement and, therefore, are a hedge, as opposed to speculating." Tr.

582. The claim that adequate documentation does not exist to determine whether the futures are a hedge or speculation cannot be sustained.

Similar assumptions have been made about the REMIC. However, Mr. Rullman made a sufficient analysis of this transaction to determine that it was not a "high risk" investment. It is not completely clear what documentation was used for this analysis. As stated, it is impossible to believe, however, that the information used was confined to oral presentations of a broker. Even the cryptic data referred to by the examiners belie that.

Paragraph B of the proposed order would prohibit Respondent from operating with inadequate equity capital for the kind and quality of assets and off-balance sheet items held.

The stated bases for this requirement are that Respondent's capital was less that 6 percent as of December 31, 1991 (it was 6.8 percent as of March 31, 1992), that during the April 1992 examination is was determined that capital was below that required by the MOU, and that it has not been determined whether the futures constituted hedging or speculation, a subject previously discussed.

The MOU required Respondent to report monthly a hypothetically computed capital ratio reflective of an assumed three hundred basis point move on its futures positions, less 70 percent of the unrealized value of its securities. The examiners discovered during the examination that the method used by Respondent to compute the value of its securities was inadequate and that when the value was properly computed, the hypothetical capital

would be about 5.9 percent after a $6,000 reduction in the securities evaluation. Tr. 765.

Assuming a legal predicate exists for this capital requirement in the proposed order, it is not clear what purpose it would serve in view of Respondent's strong capital position, though obviously it would not be burdensome to comply with.

Paragraph C of the proposed order would prohibit Respondent from engaging in securities investment and/or trading practices which produce inadequate operating income.

The target of this requirement is not readily apparent from its language. At the hearing it was explained that the prohibition refers to losses incurred in futures transactions in late 1991. Tr. 583. As stated earlier, those losses amounted to over $300,000. Whether they can be justified would seem to depend upon whether the futures position was a hedge, which I have found to be well established. It is inconsistent with the concept of hedging to require that only income be received from that activity.

The following additional information should be considered in connection with the losses that Respondent has incurred on futures contracts. According to the unrefuted testimony of Mr. Rullman, he proposed at a meeting with FDIC officials in July 1991, where the possible use of futures to hedge Respondent's claimed interest rate risk was being discussed, that the Bank enter stop-loss orders on futures contracts which would only be executed after a certain sustainable increase in interest rates had occurred. This proposal was flatly rejected by the FDIC participants to the discussion with the comment that the risk must be

fully hedged now. Tr. 675. If Mr. Rullman's proposal had been accepted, the considered losses, resulting from a decline in interest rates, would not have occurred.

(It is recognized that a stop-loss order might fail to be executed immediately if the market moves too far in one day (50 basis points), though the likelihood of the market being repeatedly locked at this limit, and not trading over a sufficiently extended period of time to erode Respondent's financial position would seem quite remote. It is not known if any of this was the basis for the FDIC's position.)

The next two provisions of the proposed order would prohibit Respondent from,

> operating with management whose policies and practices are detrimental to the Bank or engaging in management policies and practices which are detrimental to the Bank; and failing to provide adequate supervision and direction over the affairs of the Bank to prevent unsafe or unsound practices.

The assumed target of these prohibitions is Mr. Rullman, though the Bank's board would also be covered. The sought prohibition is based on the contention that the Bank has been operating under hazardous management policies and practices.

In addition to the foregoing prohibitions, the proposed cease and desist order would also require Respondent to take an extensive list of affirmative actions. Among these required actions, would be to have and retain qualified management, including a chief executive

officer. The assessment of whether the Bank has "qualified management" would be determined by management's compliance with the proposed order, applicable laws and regulations, and "not engaging in any unsafe and unsound banking practice which has an adverse effect on the Bank's asset quality, capital adequacy, earnings, or liquidity."

Within 30 days from the effective date of the proposed order the board of directors would be required to develop a written analysis and assessment of the Bank's management and staffing, including an evaluation of each Bank officer, "in particular the chief executive officer."

The shareholders of the Bank, who are also members of the board, would be required to elect a majority of "independent board members." Independent is defined in such a manner to exclude all present members.

It would seem that these requirements are preliminary steps to the ouster of Mr. Rullman from the management of the Bank, as well as from any control by him through the board. His management has already been rated a "4" by the FDIC examiners, (he was rated a "3" by the State of Missouri) and his efforts at compliance with the outstanding MOU have been uniformly rebuffed, and were made the subject of this proceeding.

It is believed that there is an insufficient basis for these seemingly harsh and punitive measures on the record presented here, even assuming the validity of many of the criticisms directed at his management. Mr. Rullman, and his wife, are the virtual owners of the bank,

and as explained, he has successfully managed it into a fairly strong institution.

Moreover, it is difficult to imagine that other responsible individuals would now accept a position on Respondent's board at reasonable compensation in view of the regulatory fire the Bank is under. If the proposed cease and desist order is adopted the duties of the directors would be difficult, if not impossible to fulfill. Any failure to comply with that order would subject the directors to possible regulatory sanctions. The Bank does not carry director liability insurance.

The outstanding MOU already requires director-shareholders to make a concerted effort to obtain a majority of independent directors. These efforts were suspended because of threatened legal proceedings (the instant matter) and a reluctance to request individuals to assume a board position in the face of these difficulties. Tr. 796.

An outside CPA who was on the board resigned after a discussion with FDIC officials in which the possibility of imposing thousand-dollar-a-day money penalties on directors was mentioned. Tr. 795.

Paragraph 2 of the proposed cease and desist order refers to Funds Management. Although these proposed requirements were described by the FDIC as "extremely similar, if not identical, to . . . the requirements of the [MOU]," they are far more stringent and rigid. Tr. 589.

The MOU requires a "policy that establishes reasonable parameters, at all time horizons, for both the ratio of

rate sensitive assets to rate sensitive liabilities, and the ratio of rate sensitive liabilities to total assets."

Respondent adopted a policy stating, in relevant part,

> * * * The Bank's policy is to insure that adverse changes in interest rates of 200 basis points do not reduce average net income by more than 50%. To accomplish this objective, the three month gap will not exceed -40% of assets, and the one year gap will not exceed -40% of assets.

As the FDIC points out this policy does not include a ratio of assets to liabilities, and does not cover periods beyond one year. It also criticizes the absence of any limitation on asset sensitivity, though it has never been suggested that this was a problem with Respondent.

The proposed order requires "a range of acceptable" ratios for rate sensitive assets and liabilities for 90 days or less, 91 days through 100 days, 181 days through one year, more than one year and not more than three years, more than three years and not more than seven years, more than seven years and not more than 15 years, and more than 15 years.

Also required would be "guidelines" for offsetting a substantial portion of the Bank's volatile deposits and borrowings with liquid, short-term assets; for ratios of loans plus other long-term earning assets that may be funded by negotiable-rate certificates of deposits and borrowings; for conditions, and maximum amounts of borrowings, and specifications of officers authorized to

borrow; and contingency plans for meeting large unexpected withdrawals and a funds management committee would be required to be established.

Paragraph 2 also contains extensive record-keeping requirements.

Paragraph 3 incorporates the various outstanding requirements pertaining to futures transactions, and is reflective of the contentions made here, and considered above, that those requirements have been inadequately complied with.

The paragraph would further require the Bank to immediately dispose of all of its interest rate futures contracts if it fails (presumably as determined by the examiners) to comply with the requirements set forth in the paragraph.

Paragraph 3(a)(ii) would mandate that the Bank's futures policy require the Bank's board of directors to,

> identify the dollar amount of income, expense or value subject to interest rate risk to be offset, and the effect on the Bank's earnings under the seven market interest rate assumptions set forth in paragraph 5 of this ORDER;

The seven market interest rate assumptions in paragraph 5 are the following:

(i) no change in market interest rates;

(ii) an immediate and sustained increase in market interest rates of 100 basis points;

(iii) an immediate and sustained decrease in market interest rates of 100 basis points,

but in no event to market interest rate of less than 1 percent per annum;

(iv) an immediate and sustained increase in market interest rates of 200 basis points;

(v) an immediate and sustained decrease in market interest rates of 200 basis points, but in no event to a market interest rate of less than 1 percent per annum.

(vi) an immediate and sustained increase in market interest rates of 300 basis points, and

(vii) an immediate and sustained decrease in market interest rates of 300 basis points, but in no event to a market interest rate of less than 1 percent per annum.

Subparagraph (b)(iii) of Paragraph 3 states that the futures policy shall also require the Bank's board of directors to:

> [S]elect the appropriate interest rate futures contract (*e.g.*, Treasury Bills, Eurodollars, etc.), and establish and verify, on a monthly basis, the degree of correlation (which shall be between 80 and 120 percent) between the dollar amount of change in (A) the aggregate market value of the interest rate futures contracts, and (B) depending on the type of item or group of items for which the interest rate risk is to be reduced, the aggregate market value, the interest income, or expense associated with such item or group of items.

Paragraph 3(c) states:

> The Bank's board of directors shall support with appropriate documentation any actions to comply with the requirements of paragraphs 3(b) (i) through and including 3(b)(vi) of this ORDER which documentation shall be made a permanent part of the Bank's records and of the minutes of the board of directors. A copy of the documentation shall be provided to the Regional Director at the same time that the Bank submits the written progress reports required by paragraph 12 of this ORDER.

Paragraph 4 would require the Bank to perform a GAP analysis under two different methods. It is said to be necessary because "despite repeated requests, this bank has, to date, still not established an appropriate, consistent method of measuring interest rate risk." Tr. 591. As discussed, this claim ignores much of the evidence in this proceeding, including in particular, the risk capital analysis presented at the hearing.

Paragraph 5 of the proposed cease and desist order would require the Bank to prepare, quarterly, written detailed estimated income statements projecting income or loss over the next 24-month period, using each of the seven interest rate assumptions set forth above, as well as other assumed conditions.

This is described as "some income modeling that will give the FDIC a couple pieces of information," as well as being an analysis of the Bank's interest rate risk, and a demonstration of whether or not a hedge works under different interest rate scenarios. Tr. 592.

Proposed paragraph 6 requires that securities activity be conducted in strict compliance with the recommendations and requirements of the FDIC Statement of Policy entitled Supervisory Policy Statement on Securities Activities, 57 Fed. Reg. 4029 (1992).

The basis stated for this requirement is the contention that the single REMIC transaction discussed above was not made in compliance with that policy and without even having a prospectus.

Paragraph 7 of the proposed order refers to adequate allowance for loan and lease allowances. There is virtually no evidence in the record on this issue.

Proposed paragraph 8 requires the Bank to have and maintain Tier 1 capital at or in excess of 7 percent of the Bank's total assets.

There are other provisions of the proposed cease and desist order referring to the payment of dividends – the prior written consent of the Regional Director and the State Commissioner is required – and auditing procedures and reports to the Regional Director.

As the foregoing discussion shows, the proposed cease and desist order is extensive and complex. Although it includes exceedingly general terms, it imposes duties to refine in improbable detail matters that are inherently uncertain. It would obviously impose an onerous burden on a Bank as small as Respondent. It is difficult to view the provisions of the order as prescriptions to promote the financial health of Respondent. It would seem fair to conclude rather that the proposed order is designed for two primary purposes, first, to

remove Mr. Rullman from the Bank, and secondly, to rid the Bank of futures transactions.

It is doubtful that the Bank would be strengthened by these actions. Its financial structure has been designed and successfully managed by Mr. Rullman. The Bank is presently strong. It is not clear that it would remain so under altered circumstances. Indeed, the proposed radical restructuring of the Bank's financial position, and the removal of Mr. Rullman, could imperil the existence of the Bank. It would require the abrupt sale of solid high yielding appreciated securities, and the substitution therefor, of short-term business loans. It is doubtful that such loans of good quality could be instantly obtained.

As a possible alternative to using short-term liabilities to fund long-term assets, Respondent has considered joining the Federal Home Loan Bank. This would provide a source of long-term loans at reasonable rates. Peat Marwick was engaged to study the cost of such loans for Respondent. Resp. Ex. 241, p. 9. However, because of its regulatory problems Respondent does not qualify for membership in that system.

The use of "swaps" has also been considered by Respondent but they were rejected because it was found that they are less liquid than futures, and require more extensive bookkeeping. Tr. 904.

The proposed order would impose heavy and detailed responsibilities on the board of directors. It seems questionable if any board would be capable of carrying out these duties, and it is even more questionable whether a new board could be constituted for Respondent that would be capable of doing so.

Undoubtedly, Respondent would benefit from independent directors. It is recognized that one-man Banks, a category into which Respondent may, arguably, be placed, are not favored institutions. It seems fairly clear, however, that the recruitment and retention of independent directors would not be assisted by the imposition of the proposed cease and desist order.

It is concluded that any practices criticized in this proceeding that should be terminated may be eliminated by authoritative statements that do not include the imposition of the proposed cease and desist order upon Respondent. Although the distrust between Mr. Rullman and the FDIC representatives in this proceeding is complete, I believe any clear statement of prescription or proscription by the board would be followed by Respondent.

For the reasons stated, I recommend that the Board, in the exercise of its discretion, not impose the proposed order.

FINDINGS OF FACT

1. The Greene County Bank, Strafford, Missouri ("Bank") is and was at all times pertinent to this proceeding, a corporation existing and doing business under the laws of the State of Missouri as an insured State nonmember bank having its principal place of business in Strafford, Missouri. Respondent's Answer ¶ 1.

2. As of February 26, 1991:

(a) the Bank's total deposits equaled $18,230,000;

(b) the Bank's total loans equaled $9,388,000;

(c) the Bank's "Tier 1 or Core Capital" as defined in section 325.2(t) of the FDIC Rules and Regulations ("Rules"), 12 C.F.R. §325.2(t) ("Tier 1 capital"), equaled $1,427,000; and

(d) the Bank's "total assets" as defined in section 325.2(v) of the Rules, 12 C.F.R. §325.2(v) ("total assets"), equaled $18,860,000. Tr. 152-153; FDIC Ex. 3-a, pp. 7-8.

3. As of March 31, 1992:

(a) the Bank's total deposits equaled $17,974,000;

(b) the Bank's total loans equaled $8,477,000;

(c) the Bank's Tier 1 capital equaled $1,386,000; and

(d) the Bank's total assets equaled $20,371,000. Tr. 291-292; FDIC Ex. 16-a, pp. 18-19.

4. As of February 28, 1993:

(a) the Bank's total deposits equaled $17,058,000;

(b) the Bank's total loans equaled $7,195,000;

(c) the Bank's Tier 1 capital equaled $1,481,000; and

(d) the Bank's total assets equaled $19,046,000. Tr. 390-391; FDIC Ex. 21-a, p. 38.

5. At all times pertinent hereto, the Bank maintained capital in excess of the regulatory minimums (without including securities appreciation):

Date	Ratio
2/26/91	7.67
3/31/92	6.8
2/28/93	7.9

FDIC Exs. 3-a at p. 8, 16-a at p. 20, 21-a at p. 20.

6. The Bank experienced annual net income as follows:

Year	Amount
1985	126,000
1986	157,000
1987	203,000
1988	220,000
1989	200,000
1990	212,000
1991	24,000
1992	195,000

Resp. Ex. 288D at p. 11, FDIC Exs. 3-a at p. 9, 16-at p. 21, 21-a at p. 22.

7. The securities appreciation in the Bank's portfolio at various times pertinent hereto was:

Date	Amount
2/26/91	373,000
3/31/92	478,000
2/28/93	511,000

FDIC Exs. 3-a at p. 8, 16-a at p. 19, 21-a at p. 41.

8. The Bank's holding company is examined by the Federal Reserve. In its most recent examination concluded as of September 15, 1993, the holding company received a "2" rating. Resp. Ex. 259.

9. Funds management for a bank is an analysis of the volume of assets and the volume of liabilities and the timing of their maturity or repricing in relationship to each other. Interest rate risk is a component of funds management regarding the volume of assets and liabilities and the interest rate attached to those assets and liabilities FDIC (Exs. 2-a, 2-b and 2-c), as well as the timing of the maturity or repricing of those assets and liabilities to view the exposure of a bank's earnings and capital to future changes in interest rates. Tr. 56-58.

10. A certain amount of interest rate risk is inherent and appropriate in commercial banking. Resp. Ex. 285 at p. 48208; Tr. at 518.

11. The level of interest rate risk of any individual bank is difficult to measure precisely. Resp. Ex. 285 at p. 48208; Tr. at 518.

12. Interest rate risk has not been a principal threat to the financial health of commercial banks in the past. Resp. Ex. 285 at p. 48208; Tr. at 519.

13. "Maturity" refers to the time at which, under contract, the principal amount of a loan, for an example of an asset, or a certificate of deposit, for an example of a liability, becomes due and payable. Tr. 77. "Repricing" refers to the opportunity prior to maturity to change the interest rate on such an asset or liability, such as under an adjustable rate mortgage as an example where, under

contract, the interest rate is not fixed over the life of the contract but is adjustable at specified time periods, at which time the mortgage may be "repriced." Tr. 77.

14. To depict and analyze a bank's interest rate risk, the FDIC examiners utilize a "gap analysis model" ("GAP analysis") which is prepared by comparing the volume of assets and liabilities subject to interest rate adjustment by reason of maturity or repricing ("rate-sensitive assets" and "rate-sensitive liabilities," respectively) within specified time periods, usually of zero to three months ("3-month period"), zero to six months ("6-month period"), zero to twelve months ("12-month period"), and another time period if necessary to include in the analysis at least 75 percent of the rate-sensitive assets and rate-sensitive liabilities. Tr. 77-81; FDIC Ex. 2-d.

15. In preparing a GAP analysis, rate-sensitive assets are placed within the specified time periods based upon when the asset will mature or reprice or when the bank will receive the "cash flow principal" from those assets and likewise, rate-sensitive liabilities are placed within the time periods during which they mature or reprice. Tr. 78-79; FDIC Ex. 2-d, pp. 1-2.

16. Upon identifying the dollar volume of rate-sensitive assets and rate-sensitive liabilities maturing or subject to repricing at the designated time periods, a GAP analysis then compares the total volume of these assets and liabilities within each time period to find the dollar amount and the degree of any imbalance within each time period. Tr. 95-101; FDIC Ex. 2-d, p. 3.

17. The GAP analysis for each time period reviewed generally consists of three calculations and determinations:

(a) The "net position of assets," calculated by the total rate-sensitive assets for a given time period, less the total rate-sensitive liabilities in the same time period, for a net positive or negative amount as the case may be;

(b) the "net position of assets as a percentage of total assets," computed by taking the calculation above for a net position of assets in each time period and dividing it by the total assets of the bank, which provides the amount of what is commonly called "the GAP" for that time period; and

(c) "rate-sensitive assets as percentage of rate-sensitive liabilities," computed by dividing the total volume of assets by the total volume of liabilities for each time period. Tr. 96-101; FDIC Ex. 2-d, p. 3.

18. When the "net position of assets" is a negative amount in a given time period, which also results in a negative percent for the "net position of assets as a percentage of total assets" in that time period, the bank is "liability-sensitive" for that time period. Tr. 96-98. The interest rate risk of a liability-sensitive bank is that an increase in interest rates, because of the greater volume of repricing liabilities, will result in increased interest expenses without a similar increase in offsetting interest income, thereby lowering the bank's net interest income for the period at issue. Tr. 96-98; FDIC Ex. 2-d.

19. Generally, GAP analysis is used to analyze interest rate risk to short-term (12 months or less) earnings. Tr. 106.

20. The net dollar position of assets (liabilities) and the net position as a percent of total assets can be used to project estimated changes in net interest income based upon a change in interest rates. For instance, in a bank that is liability-sensitive in the 12-month period, the impact of an immediate and sustained one percent increase in interest rates over a 12-month period could be projected as follows:

(a) the net position of assets, being a negative amount for the 12-month period, multiplied by one percent, will equal the dollar amount of the projected negative impact on income for that period; and

(b) the net position of assets as a percent of total assets, being a negative percent for the 12-month period, multiplied by one percent, will equal the projected basis point (1/100 of 1%) decrease in the bank's percentage return on assets for that period. Tr. 103-106; FDIC Ex. 2-d, p. 4.

21. The calculation of rate-sensitive assets as a percentage of rate-sensitive liabilities is made to determine the amount of rate-sensitive assets that are offset by rate-sensitive liabilities in a given time period. Tr. 101. Examiners view as a generally accepted range or level for that percentage to be 80 to 120 percent, unless a bank has made further analysis that supports the safety of such a position. Tr. 101-102; FDIC Ex. 2-d.

22. In addition to GAP analysis, there are other generally accepted methods for measuring interest rate risk, such as duration and simulation models, which are more complicated and take into consideration more assumptions and, depending on the accuracy of the assumptions, could be more accurate than a GAP analysis. Tr. 109-141.

23. Duration analysis is the time weighted average of cash flows expressed in present value terms based on the rate-sensitive assets and rate-sensitive liabilities held by a bank. Tr. 109; FDIC Ex. 1-a, p. 5.2-2. Duration analysis requires very complex calculations and continuous updating of information because duration will change as interest rates change and as changes occur in time, *e.g.*, volume and nature of the items on the balance sheet. Tr. 110-111.

24. Pursuant to the FDIC Manual of Examination Policies, the FDIC will review a bank's duration analysis of interest rate risk if presented during an examination. Tr. 109-111; FDIC Ex. 1-a, p. 5.2-4.

25. A simulation model, generally, is a computerized model that will take a base of information from a bank's balance sheet and income statement, and then project changes resulting from different scenarios. Tr. 111-112. Such scenarios may include growth or decline in assets, growth or decline in deposits, impact of changes in interest rates on those items, and may include various levels of assumptions such as changes in interest rates within a 12-month period, the rate or speed at which such interest rates will change, and what effects those changes will have on the nature and composition of the balance

sheet and income statement. Tr. 111-140; FDIC Exs. 2-e through 2-h.

26. During the FDIC's examination of the Bank as of February 26, 1991, the GAP analysis performed by the FDIC reflected, as set forth in FDIC Ex. 3-a at page 10, the following:

(a) the Bank's total rate-sensitive assets formally maturing or otherwise formally subject to interest rate adjustment within time periods of six months, one year and five years were $1,983,000, $2,713,000 and $9,441,000, respectively;

(b) the Bank's total rate-sensitive liabilities maturing or otherwise subject to interest rate adjustment within time periods of six months, one year and five years were $15,315,000, $16,574,000 and $16,981,000, respectively;

(c) the Bank's net position of assets (liabilities), based on the above figures were for the six-month, one-year and five-year time periods was a negative $13,332,000, a negative $13,861,000 and a negative $7,540,000, respectively;

(d) the Bank's net position, based on the above figures, of assets as a percent of total assets in the six-month, one-year, and five-year time periods was a negative 67.11 percent, a negative 69.77 percent, and a negative 37.95 percent, respectively;

(e) the Bank's rate-sensitive assets as a percent of rate-sensitive liabilities in the six-month, one-year, and five-year time periods were

12.95 percent, 16.37 percent, and 55.60 percent, respectively, according to the figures used. Tr. 154-161.

27. Based on the Bank's interest rate risk thus computed as of February 26, 1991, and assuming net income for the next 12 months would otherwise equal the Bank's 1990 net income of $212,000 with a return on assets of 1.18 percent, the projected impact on that income from an immediate and sustained one percent increase in interest rates would be a decline of between $134,000 and $139,000, and a decline in the percentage return on assets of between 67 and 70 basis points, thereby reducing net income to between $73,000 and $78,000 and the return on assets percent to between 0.48 and 0.51 percent. Tr. 167-168; FDIC Ex. 3-e. This range of calculations was based upon whether the interest rate risk analysis includes assumptions for prepayment and amortization estimates for GNMA security pools owned by the Bank. Tr. 167-170, 333; FDIC Ex. 3-e.

28. As of February 26, 1991, the Bank's funds management policy did not address the management or monitoring of interest rate risk, even though the FDIC recommended such additions to that policy in its prior Report of Examination as of December 8, 1989. Tr. 179-180; Ex. 3-d, p. 14. The minutes from the meetings of the Bank's board of directors from January 1990 through February 1991 make no indication of any review and approval by that board of any interest rate risk analysis performed by the Bank. Ex. 31, pp. 126. As funds management and investment policy covering interest rate risk was adopted by the board on April 23, 1991. FDIC Exs. 15, p. 3 and 16-b-2.

29. During the FDIC's examination of the Bank as of April 3, 1992, the Bank's financial information used for that examination was as of March 31, 1992, and the GAP analysis performed by the FDIC reflected as set forth in FDIC Ex. 16-a at page 14, the following:

(a) The Bank's total rate-sensitive assets maturing or otherwise subject to interest rate adjustment within time periods of three months, six months, one year and three years were $1,892,000, $3,508,000, $5,964,000 and $12,800,000, respectively.

(b) the Bank's total rate-sensitive liabilities maturing or otherwise subject to interest rate adjustment within periods of three months, six months, one year and three years, were $9,692,000, $14,485,000, $15,902,000, and $16,255,000, respectively;

(c) the Bank's net position of assets (liabilities) in the three month, six month, one year and three year time periods was a negative $7,800,000, a negative $10,977,000, a negative $9,938,000, and a negative $3,455,000, respectively;

(d) the Bank's net position of assets as a percent of total assets in the three month, six month, one year and three year time periods was a negative 38.80 percent, a negative 54,60 percent, a negative 49.43 percent, and a negative 17.19 percent, respectively; and

(e) the Bank's rate-sensitive assets as a percent of rate-sensitive liabilities in the three month, six month, one year and three year

time periods were 19.52 percent, 24.22 percent, 37.50 percent, and 78.75 percent, respectively. Tr. 308-316.

30. By reason of the imbalance of the Bank's rate-sensitive assets to rate-sensitive liabilities as of March 31, 1992, excluding any consideration to off-balance sheet items, the Bank was heavily liability sensitive. Tr. 317.

31. Based on the Bank's interest rate risk, according to FDIC's GAP analysis, as of March 31, 1992, and assuming net income for the next 12 months would otherwise equal the Bank's 1991 net income of $24,000 with a return on assets of 0.12 percent, the projected impact on that income from an immediate and sustained one percent increase in interest rates would be a decline of between $99,000 and $119,000, and a decline in the percentage return on assets of between 49 and 59 basis points, thereby eliminating net income and causing a net loss of between $75,000 and $95,000, and a return on assets of between a negative 0.37 and a negative 0.47 percent. Tr. 318-325; FDIC Ex. 3-c. This range of calculations was based upon whether the interest rate risk analysis includes assumptions for prepayment and amortization assumptions for GNMA security pools owned by the Bank. Tr. 318-325, 333; Ex. 3-c.

32. During the examination of the Bank performed by the State of Missouri as of March 10, 1993, a GAP analysis was prepared based on financial information as of December 31, 1992, and reflected, as set forth in FDIC Ex. 21-a at page 44, the following:

(a) the Bank's total rate-sensitive assets maturing or otherwise subject to interest rate adjustment within time periods of three

months and twelve months were $1,195,000 and $3,606,000, respectively;

(b) the Bank's total rate-sensitive liabilities maturing or otherwise subject to interest rate adjustment within time periods of three months and twelve months were $9,609,000 and $13,539,000, respectively;

(c) the Bank's net position of assets (liabilities) in the three month and twelve month time periods was a negative $8,414,000 and a negative $9,933,000, respectively;

(d) the Bank's net position of assets as a percent of total assets in the three month and twelve month time periods was a negative 45.4 percent and a negative 53.6, respectively; and

(e) the Bank's rate-sensitive assets as a percent of rate-sensitive liabilities in the three month and twelve month time periods were 12 percent and 27 percent, respectively. Tr. 392-393.

33. The Bank was heavily liability sensitive, according to its balance sheet, as of December 31, 1992. Tr. 393-394.

34. Based on the Bank's interest rate risk as depicted in the state's report of examination, and assuming the net income for the next twelve months would otherwise equal the Bank's 1992 net income of $195,000 with a return on assets of 1.0 percent, the projected impact on that income from an immediate and sustained one percent increase in interest rates would be a decline of between $99,000 and $117,000, and a decline in the percentage return on assets of between 53 and 63 basis points, thereby reducing net income to between $78,000

and $96,000 and the return on assets percent to between 0.37 and 0.47 percent. Tr. 394-399; FDIC Ex. 22. This range of calculations was based upon whether the interest rate risk analysis includes assumptions for prepayments and amortization estimates for GNMA security pools owned by the Bank. Tr. 333, 394-399; FDIC Ex. 22.

35. The most recent FDIC examination, as of November 12, 1993, found that "the bank's liability sensitive [interest rate risk] position had improved since the previous [FDIC] examination." FDIC Ex. 28.

36. The FDIC examination as of November 12, 1993, also found that "the bank's capital had increased since the prior examination." FDIC Ex. 28.

37. A July 1, 1993 FDIC analysis of the Bank found that absent a "substantial change" in interest rates, the Bank "does not pose an immediate risk to the Bank Insurance Fund." Resp. Ex. 209.

38. The FDIC examination in 1992 found that the Bank "exceeds all of the risk based capital requirements" and that the Bank's "[r]isk-based capital ratio remains well above peer." FDIC Ex. 16-a at pp. 5, 20.

39. Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 requires the federal banking agencies to revise existing risk-based capital standards to take adequate account of interest rate risk. The FDIC, the Federal Reserve Board and the Office of the Comptroller of the Currency initially sought comment on a possible framework for measuring interest rate risk in august 1992. In 1993, the three agencies, including

FDIC, promulgated new proposed standards for measuring interest rate risk, which would revise the risk-based capital standards to ensure that banks measure and monitor their interest rate risk and maintain adequate capital for the risk. Resp. Ex. 285; 58 Fed. Reg. 48206 (Sept. 14, 1993).

40. FDIC made no attempt to apply the new proposed standards for measuring interest rate risk in connection with its evaluation of the Bank's interest rate risk. Tr. at 840.

41. The new proposed standards for measuring interest rate risk address numerous issues not accounted for in a gap analysis such as that used by FDIC and provide a more accurate measure of interest rate risk. Tr. at 995-96; Resp. Ex. 285.

42. Application of the new proposed standards for measuring interest rate risk shows that the Bank's risk-based capital far exceeds regulatory minimums when adjusted for interest rate risk pursuant to the regulation. Tr. at 841-55; Resp. Exs. 305, 306.

43. The concept of liquidity is a bank's ability to sustain a decline in deposits and fund its assets in a profitable manner. Tr. 57.

44. Two aspects of a bank's liquidity analyzed by the FDIC are: first, a comparison of a bank's net cash, short term, and marketable assets to its net deposits and short term liabilities to calculate a quantitative measure known as the "liquidity ratio;" and second, an analysis of

the method of funding that liquidity to evaluate the stability or volatility of that funding. Tr. 172, 329-330; FDIC Exs. 3-a, p. 32; 16-a, p. 48; 21-a, p. 47.

45. In analyzing the methods of funding for liquidity, a comparison is made of short term investments in relationship to "volatile liabilities," which normally are either short term in nature or are generally viewed as deposits that will decline or increase by reason of a bank's pricing of those deposits in comparison to the market rates, and thus are not considered a stable base of funding. Tr. 172-173. The funds from such short term maturing investments are assumed to be available to fund the volatile liabilities should they fail to remain at the bank. Tr. 172-174. Thus, in the absence of sufficient short term investments, a bank would have to either attract replacement volatile liabilities, or obtain some other type of funding to replace the maturing volatile liabilities. Tr. 173-174. The significance of this analysis is that in the absence of sufficient short term investments, if interest rates increase, such funding through additional short term deposits or borrowings will be more costly. Tr. 174. Under such circumstances, if the bank chooses to obtain such funding by liquidating assets, it will have to sell long term, normally higher yielding assets, which under increasing interest rates will have declined in value. Tr. 174. Thus, under such circumstances and upon an increase in interest rates, the risk to the bank is that earnings will decline. Tr. 174-176.

46. In evaluating borrowing as a method of funding, there is an inherent difficulty in estimating a bank's ability to obtain funds in the market because until a bank actually attempts to borrow, it cannot determine with

confidence whether funds will be available at a price that will maintain a positive yield spread for the bank. FDIC Ex. 1-a, pp. 6.1-2, 6.1-3. Changes in money market conditions may cause rapid deterioration of a bank's capacity to borrow at a profitable rate. FDIC Ex. 1-a, pp. 6.1-2, 6.1-3; FDIC Ex. 16-a, p. 1-a-2.

47. As of February 26, 1991 the Bank's short term assets were 33.74 percent of the Bank's short term volatile liabilities; and

48. As of March 31, 1992 the Bank's short term assets were 5 percent of the Bank's short term volatile liabilities. The Bank's policy regarding any needs for liquidity was to rely on funding such needs through borrowings or sale of liquid assets.

49. As of February 28, 1993:

(a) the Bank's short term assets were 1.64 percent of the Bank's short term volatile liabilities;

(b) the Bank was frequently relying on borrowings or the sale of assets to fund its liquidity needs; and

50. The Bank's liquidity position is bolstered by the ready availability of its appreciated securities and the stability of its deposit base, and the Bank is well prepared to meet any liquidity needs. The Bank's liquidity position does not present any abnormal risk or reasonably direct effect on the Bank's financial soundness. Tr. at 641-48, 658-59; Resp. Exs. 297, 298.

51. A futures contract is an agreement between two parties, a buyer (characterized as a "long position") and a

seller (characterized as a "short position"), for the sale of a specified commodity (in this case being interest rate-sensitive securities) at a specified date. Tr. 144-145; FDIC Ex. 6-a. Upon arrival of the specified date, or prior to that time, a party to a futures contract will generally "close their position," in that the individual will not actually deliver or receive the security, but instead will take a position in an "offsetting contract." Tr. 145-148. An "offsetting contract" would be a contract for the same security and sale date as the original contract, but under which the party would take the opposite position (buyer or seller) from that held in the original contract. Tr. 145-148. A gain or loss would be recognized on the difference of the price in the original contract and the price in the offsetting contract. Tr. 145-148; FDIC Ex. 6-a.

52. A "hedge" transaction is a transaction used to offset a market risk in one transaction by assuming a market risk of the opposite nature in a separate transaction. Tr. 211-222; FDIC Exs. 6-a; 6-d. These opposing financial positions protect against unfavorable market movements, thereby reducing the overall risk of loss with respect to the item being hedged. Tr. 211-222; FDIC Exs. 6-a; 6-d.

53. The Bank has executed a strategy of hedging its liability portfolio with financial futures to control interest rate risk. This strategy was initiated at a time when there was a previous FDIC Notice of Charges, concerning interest rate risk, pending against the Bank. That Notice of Charges was dismissed after the parties entered into the MOU. Tr. at 677, 694-95.

54. Hedging with financial futures is a valid and proven method for controlling interest rate risk. Tr. at 186, 517, 518, 969-70; FDIC Ex. 21-a at p. 58.

55. The Bank's initial efforts concerning the financial futures market and hedging were authorized at board of directors meetings held on April 23, 1991, and June 27, 1991. At the latter meeting, the board resolved to enter into contractual relationships with certain brokerage firms. FDIC Ex. 31; Tr. at 671.

56. The Bank executed a confirmation to its brokerage firm that its purchase of futures contracts was for the purpose of hedging. GCB Ex. 266; Tr. at 671.

57. In September 1991, the Bank entered into approximately 80 futures contracts with maturities of March 1992, which obligated the Bank to sell in the future $80,000,000 of U.S. Treasury Bills and Eurodollar securities, as well as an option contract in which the Bank was obligated to honor an option to sell to a buyer specified futures contracts at a price fixed as of September 10, 1991, if the option was exercised prior to November 16, 1991. Respondent's Answer ¶ 7. The first acquisition of futures contracts was the acquisition of 20 contracts of September 9, 1991. FDIC Ex. 10-b, p. 6. The subsequent acquisitions occurred on September 13, 1991 (20 futures contracts and the option contract), September 24, 1991 (20 contracts), and September 26, 1991 (20 contracts). FDIC Ex. 10-b, p. 6.

58. The futures contracts covered by the option contract had to have a maturity of December 31, 1991, with the underlying securities being U.S. Treasury Bonds of $1,000,000 par value. Respondent's Answer, ¶ 7; FDIC Ex.

10-b. The option contract was a "naked call option" in that the Bank was obligated to honor an option to sell certain futures contracts on or before November 16, 1991, to a buyer at a certain price fixed as of September 13, 1991, when in fact the Bank did not own the subject futures contracts, nor the underlying U.S. Treasury Bonds. Tr. 226, 941-942. Accordingly, if the holder of the option exercised it in accordance with its terms, the Bank would have to purchase the subject futures contracts at the then current market price and sell them to the option holder at the price fixed as of the date of the option. Respondent's Answer, ¶ 7; Tr. 232-233.

59. With respect to the acquisition of futures contracts, the Bank made its first acquisition on September 9, 1991, by entering into 20 contracts. Tr. 243-244; FDIC Ex. 10-b, p. 6. However, the Bank's board of directors did not discuss the Bank's actual acquisition of those futures contracts until its meeting of September 10, 1991. Tr. 242-244, 938-939; FDIC Exs. 7, p. 1; 31, p. 40.

60. At a September 10, 1991 board of directors meeting, President Rullman presented information to the board on hedging with financial futures. In particular, he guided the directors through the process of acquiring futures using *The Wall Street Journal* and other information. FDIC Exs. 31, 31-b; Resp. Ex. 232; Tr. at 679-82, 685-86.

61. The Bank commissioned a study of interest rate futures correlation by the firm of KPMG Peat Marwick. The firm's report was completed in December 1991 and was made available to FDIC. Resp. Ex. 241; Tr. at 342-43, 521, 522-523, 537, 544, 707.

62. FDIC concluded that the KPMG Peat Marwick study "did show correlation between the institution's liabilities and stated values for futures contracts." Resp. Ex. 214; Tr. at 522-23.

63. A report by the IBAA Securities Corporation, which reviewed the Bank's portfolio, showed a significant reduction in the Bank's interest rate risk under an FDIC-like GAP analysis after the hedge was properly taken into account. Tr. at 777-81; FDIC Ex. 30.

64. As determined in the FDIC's examination of the Bank as of April 3, 1992, the Bank had entered into and was holding 80 futures contracts which obligated the Bank to sell in the future $80,000,000 of U.S. Treasury Bills with maturities ranging from June 1992 to September 1992, and which were different contracts from those acquired previously in September 1991. Respondent's Answer ¶ 8; Tr. 335-336; FDIC Exs. 16-a, p. 23; 16-b-6.

65. (a) As determined in the State's examination of the Bank as of March 10, 1993, the Bank had entered into and was holding 120 futures contracts:

(i) 60 of which by their terms obligated the Bank to make future sales (short) of U.S. Treasury Bills in a par amount of $60,000,000, with contract maturities of June 1993;

(ii) 40 of which by their terms obligated the Bank to make future sales (short) of Eurodollar securities in a par amount of $40,000,000 – 20 with contract maturities of March, 1993, and 20 with contract maturities of June 1993; and

(iii) 20 of which by their terms obligated the Bank to make future purchases (long) of Eurodollar securities in a par amount $20,000,000, with contract maturities of December 1993. Respondent's Answer ¶ 8; Tr. 403-404; FDIC Ex. 21-a, p. 38.

(b) On March 24, 1993, the Bank replaced some of its contracts with new contracts with different maturities and entered into 40 additional futures contracts, 20 of which by their terms obligated the Bank to make future sales (short) of Eurodollar securities in a par amount of $20,000,000, and 20 of which by their terms obligated the Bank to make future purchases (long) of Eurodollar securities in a par amount of $20,000,000, for a total of 160 futures contracts in a par amount of $160,000,000, with 120 short contracts having contract maturities ranging from June to December 1993, and 40 long contracts having contract maturities ranging from June to September 1994. Respondent's Answer, ¶ 8; Tr. 403-404; FDIC Ex. 21-a, p. 58;

(c) As of October 27, 1993, the Bank had entered into an [sic] was holding 240 futures contracts:

(i) 100 of which by their terms obligated the Bank to make future sales (short) of Eurodollar securities in a par amount of $100,000,000, with contract maturities of March 1994.

(ii) 60 of which by their terms obligated the Bank to make future sales (short) of U.S. Treasury Bills in a par amount of

$60,000,000, with contract maturities of March 1994; and

(iii) 80 of which by their terms obligated the Bank to make future purchases (long) of Eurodollar securities in a par amount of $80,000,000, with contract maturities of December 1993 for 40 contracts, June 1994 for 20 contracts, and September 1994 for 20 contracts. Tr. 430-432; FDIC Ex. 27.

66. A July 23, 1992 FDIC analysis of the Bank found that "it appears that Chairman Rullman's hedge theoretically offsets a liability sensitive [interest rate risk] position," and that absent a substantial change in interest rates the Bank did not pose an immediate risk. Resp. Ex. 218.

67. The Bank's basic hedging program has been confined to the use of short-term financial instruments to hedge short-term liabilities. This type of hedging entails comparably little risk when contrasted with other potential hedging strategies. Tr. at 976-81; Resp. Ex. 308.

68. As indicated above, the Bank first entered into futures contracts in September 1991. The Bank's net income year-to-date as of September 30, 1991, was $254,000. Tr. 370; FDIC Ex. 11, p. 2. As of December 31, 1991, the Bank's 1991 net income was reduced by more than $225,000 to $24,000, with a reduced return on assets of only .12 percent. Tr. 370; FDIC Ex. 12. This reduction in earnings in 1991 was due to a loss of $301,000 suffered by the Bank on its futures contracts. Tr. 371; FDIC Ex. 16-a, pp. 3, 21-23.

69. As of April 3, 1992, the Bank was experiencing a $72,000 gain on its year-to-date position in futures contracts. Tr. 371. However, by year-end 1992, the Bank lost that gain plus $164,000. Tr. 412; FDIC Ex. 21-a, p. 23. That nine month loss of $236,000 on futures contracts reduced the Bank's year-end net income and return on average assets to $195,000 and one percent, respectively. FDIC Ex. 21-a, p. 22.

70. For the first two months of 1993, the Bank lost $55,000 on its futures contracts. Tr. 412-413; FDIC Ex. 21-a, p. 23.

71. The Bank's net losses on futures contracts during the approximately 18 month period of September 1991 through February 28, 1993, equaled $520,000, an amount more than one-third of the Bank's Tier 1 capital as of February 28, 1993. Tr. 412, 390-391, FDIC Ex. 21-a, pp. 23, 38.

72. The Bank's basic hedging program using short positions in financial futures has been effective in controlling the Bank's interest rate risk. Gains and losses in the Bank's liability portfolio have been offset by the corresponding gains and losses incurred in the short positions in financial futures contracts. Tr. at 631-32, 699-703; Resp. Exs. 218, 272, 273; Tr. at 971-73; Resp. Ex. 307. As the strategy has been executed by the Bank, it has presented no abnormal risk of loss to the Bank. Tr. at 981, 1008.

73. When considered in context with the Bank's capital position and appreciated securities portfolio, the Bank's strategy could not reasonably have adversely affected on the Bank's financial soundness. This point is

illustrated by the FDIC's April 3, 1992 report of examination, at page 4-1-a. FDIC Ex. 16-a at p. 23. Under the FDIC's analysis, it appears that were interest rates to fall to zero the Bank's futures losses would be less than the appreciation in its securities portfolio. Conversely, if interest rates were to increase, the Bank would realize gains from the futures. Tr. at 465-67, 996-1000.

74. In connection with its supervision of the Bank, the State consulted with several banks who advised that "the viability of bank was not threatened in a worst case scenario." Resp. Ex. 277. The State concluded that "foreseeable losses would largely be offset with securities gains [with] no substantial impact to capital" and that it "could not show the bank has been actually harmed." *Id.*

75. Among the FDIC's criticisms of the Bank was the cost of the Bank's hedging program. FDIC Ex. 16-a at p. 26. Beginning in late 1992 and pursuant to a written strategy, Tr. at 799, FDIC Ex. 21-b-5, the Bank acquired long positions in financial futures as an investment strategy designed to reduce the expense of the basic hedging program in the then-current rate environment. Tr. at 801-02. The long positions have effectively reduced the expenses of the Bank's basic hedging program, and they do not present any abnormal risk or reasonably direct effect on the Bank's financial soundness. Tr. at 801-02, 1019. The positions were consistent with the Bank's policy, Tr. at 803, and were reviewed by the board's ALCO Committee. Tr. at 804-05, FDIC Ex. 32 (minutes from February 26 and March 29, 1993).

76. As reflected above, the Bank's net annual income for 1991 dipped to $24,000. In the previous year,

1990, it had been $212,000 and in the subsequent year, 1992, it was $195,000. *Supra* ¶ 3. The dip in 1991 year-end earnings is not, however, reflective of any practice or condition at the Bank that presented abnormal risk or a reasonably direct effect on its financial soundness. The Bank's basis hedging program had been instituted in the fourth quarter of 1991. As a consequence, the Bank was required to book futures losses at year-end, before it realized the offsetting gains from the repricing of its liabilities in the following year. Viewed without reference to year-end accounting conventions, the Bank's earnings were relatively stable during the time periods at issue here. Tr. at 613-15, 974-76.

77. The Bank entered into a Memorandum of Understanding ("MOU") with the FDIC on February 14, 1992. Paragraph 11(a) of the MOU required the Bank to maintain Tier 1 capital of six (6) percent of average total assets. FDIC Ex. 13.

78. In response to the requirements of the MOU, the Bank submitted voluminous materials to FDIC. In its initial "MOU response" on March 11, 1992, the Bank submitted an Asset/Liability Management Policy Statement, and Interest Rate Strategy, a Funds-Management and Investment Policy, draft Asset and Liability Committee minutes, and supporting information. These submissions fulfilled in all material respects the bank's obligations under paragraphs 1(a), 1(b), 1(c), and 9(a)(i) of the MOU. FDIC Ex. 15; Tr. at 739-51.

79. The Bank's Asset/Liability Management Policy Statement submitted to the FDIC on March 11, 1992, had

previously been provided to the FDIC in draft form without adverse comment. FDIC Ex. 15; Resp. Ex. 233; Tr. at 711-12.

80. After its initial submission, the Bank provided regular reports to the FDIC pursuant to the MOU and regarding the Bank's position generally, including the following:

Resp. Ex. 216	–	4/15/92 letter from GCB to FDIC with actions taken to comply with MOU
Resp. Ex. 217	–	5/15/92 letter from GCB to FDIC with MOU report
Resp. Ex. 219	–	7/14/92 letter from GCB to FDIC with MOU report
Resp. Ex. 221	–	8/8 92 letter from GCB to FDIC with MOU report
Resp. Ex. 222	–	8/14/92 letter from GCB to FDIC regarding overall condition of bank
Resp. Ex. 224	–	9/4/92 letter from GCB to FDIC with MOU report
Resp. Ex. 225	–	10/9/92 letter from GCB to FDIC with MOU report
Resp. Ex. 226	–	12/7/92 letter from GCB to FDIC with MOU report
Resp. Ex. 201	–	1/7/93 letter from GCB to FDIC with MOU report
Resp. Ex. 202	–	2/1/93 letter from GCB to FDIC with MOU report
Resp. Ex. 203	–	3/4/93 letter from GCB to FDIC with MOU report

Resp. Ex. 204	–	3/8/93 letter from GCB to FDIC with corrected MOU report
Resp. Ex. 205	–	4/9/93 letter from GCB to FDIC with MOU report
Resp. Ex. 207	–	5/13/93 letter from GCB to FDIC with MOU report
Resp. Ex. 23	–	5/11/93 letter from GCB to FDIC with ALCO minutes
Resp. Ex. 208	–	6/1/93 letter from GCB to FDIC with MOU report
Resp. Ex. 211 and Ex. 257	–	7/9/93 letter from GCB to FDIC with MOU report
Resp. Ex. 258	–	8/2/93 letter from GCB to FDIC regarding overall condition of bank

See also Tr. at 739-51, 766-75, 781-84, 794, 797-98, 806-07, 811-12, 814. These submissions show that, consistent with paragraph 11 of the MOU, the Bank at all times maintained adequate capital at the levels and pursuant to the calculations and adjustments required by the MOU.

81. The MOU required the Bank to submit its policies to FDIC for "review and comment, and required a response from the FDIC Regional Director. The FDIC never specifically responded to the policies submitted by the Bank. Tr. at 750-51; GCB Ex. 206.

82. In February 1992, the Bank purchased as an investment a Federal National Mortgage Real Estate Mortgage Investment Conduit ("FNMA REMIC") in the amount of $150,000. Tr. at 721. Prior to acquiring the

FNMA REMIC, an analysis of the security was performed by President Rullman, Tr. at 722-23; Resp. Ex. 239 at p. S-38, who concluded within his authority and ability that the FNMA REMIC was not a "high risk security" under FDIC guidelines. Tr. at 222-24; *see also* Tr. at 1002. Such securities are not supposed to be sold without the prior delivery of a prospectus, Tr. at 100, and the instrument here passed the applicable regulatory test. FDIC Ex. 30 at p. 65; Tr. at 728. The FNMA REMIC paid off within one year and resulted in no loss to the Bank. Tr. at 725. It was intended to be a liquid, short-term, high-yield investment for the Bank, and it performed as anticipated. Tr. at 724-25. The acquisition of the FNMA REMIC did not present an abnormal risk to the Bank and had no reasonably direct effect on the Bank's financial soundness.

83. All statements of fact in the above Discussion of Facts and Law are incorporated herein by reference.

CONCLUSIONS OF LAW

1. The Respondent is and was, at all times pertinent to this proceeding, an insured state nonmember bank subject to the Federal Deposit Insurance Act ("Act"), 12 U.S.C. §§ 1811-1831t, and the FDIC's Rules and Regulations, 12 C.F.R. Chapter III.

2. The FDIC has jurisdiction over the Bank, the Bank's "institution-affiliated parties" as that term is defined in section 3(u) of the Act, 12 U.S.C. § 1813(u), and the subject matter of this proceeding.

3. The FDIC has the authority to issue an order to cease and desist against the Bank pursuant to section 8(b) of the Act, 12 U.S.C. § 1818(b).

4. The FDIC's burden of proof in this proceeding is one of a preponderance of the evidence. *In the Matter of the American Bank of the South, Merritt Island, Florida,* FDIC-92-17b, 1 FDIC Enforcement Decisions and Orders ¶ 5195 at A-2233 (March 30, 1993), citing *Steadman v. Securities and Exchange Commission,* 450 U.S. 91, 102 (1981).

5. The opinions and conclusions of FDIC examiners concerning the quality and efficacy of bank operating policies and the risks associated with specific bank practices are entitled to great weight unless the opinions and conclusions are shown to be arbitrary or capricious or outside a zone of reasonableness. These opinions, however, are not unreviewable, especially on factual matters, not requiring the exercise of examiner expertise. *In the Matter of the American Bank of the South, Merritt Island, Florida,* FDIC-92-17b, 1 FDIC Enforcement Decisions and Orders ¶ 5195 at A2234 (March 30, 1993); *see also, Sunshine State Bank v. Federal Deposit Insurance Corporation,* 783 F.2d 1580 (11th Cir. 1986).

6. Respondent is not operating in an unsafe and unsound condition because of its futures contracts.

7. The Bank's sale of call options was, according to the Examination manual, an unsafe and unsound practice.

8. The Bank has complied with the MOU in material respects but it has not adopted an investment policy in full compliance with paragraph 1(c) of that agreement.

9. The Bank's acquisition of FNMA REMIC was not an unsafe and unsound practice.

10. The Bank's investment and trading practices as alleged in the Notice of Charges are not unsafe and unsound practices.

11. The Bank has not engaged in any unsafe and unsound practices that would warrant the issuance of an order to cease and desist pursuant to Section 8(b) of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b).

So Ordered this 31st day of October, 1994.

/s/ Arthur L. Shipe
Arthur L. Shipe
Administrative Law Judge

PROPOSED ORDER

Upon consideration of the record as a whole, it is hereby

ORDERED that the Notice of Charges is dismissed and, accordingly, the request for issuance of an order to cease and desist is **denied.**

FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, DC

In the Matter of THE GREENE COUNTY BANK STRAFFORD, MISSOURI (INSURED STATE NONMEMBER BANK)	**CERTIFICATE OF SERVICE** FDIC 93-160b

I am Gerald J. Langan, Law Clerk to Administrative Law Judge Arthur L. Shipe, Office of Financial Institution Adjudication, Washington, DC.

The complete Record of the above-captioned proceeding consists of the following described documents, which are filed in reverse chronological order, as set forth below:

Filed Volumes 1 & 2, containing the Recommended Decision, and Post-Hearing filings.

4 Transcripts of Proceeding, with 3 volumes of FDIC Hearing Exhibits and 3 volumes of Respondent's Hearing Exhibits.

Filed Volume 3, containing the Pre-Hearing filings.

On October 31, 1994, I caused to be served upon the following parties, the matters described below.

By Hand Delivery, a complete copy of the original Record of this proceeding upon:

Mr. Robert E. Feldman
Deputy Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, DC 20429

By Hand Delivery, a copy of the Recommended Decision upon:

Mr. Arthur L. Beamon
Associate General Counsel
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, DC 20429

By Federal Express Delivery, a copy or the Recommended Decision upon:

Mr. Gerald F. Lamberti, Esq.
Regional Counsel, FDIC
2345 Grand Avenue, Suite 1500
Kansas City, Missouri 64108

And by the same method, a copy of the Recommended Decision upon:

Ms. Lynn R. Dadisman, Esq.
Mr. John J. Oldenburg, Esq.
Federal Deposit Insurance Corporation
2345 Grand Avenue, Suite 1500
Kansas City, Missouri 64108

Mr. Charles W. German, Esq.
Mr. Brant M. Laue, Esq.
Rouse, Hendricks, German, May & Shank, P.C.
One Petticoat Lane Building
1010 Walnut, Suite 400
Kansas City, Missouri 64106

Dated this 31st day of October, 1994, at Washington, DC.

/s/ Gerald J. Langan
Gerald J. Langan
Law Clerk to Judge
Arthur L. Shipe
Administrative Law Judge